CITY NETWORK INC
Form 10KSB/A
January 27, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB
(Amendment No. 2)

[ ] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended ______________

[X] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from March 1, 2004 to December 31, 2004

Commission File Number: 333-61286

CITY NETWORK, INC.
(Exact name of small business issuer as specified in its charter)

Nevada	88-0467944
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2F-1, No. 16, Jian Ba Road, Jhonghe City
Taipei County 235, Taiwan, ROC N/A
(Address of principal executive offices) (Zip Code)

Issuer's Telephone Number: 011-886-2-8226-5566

Securities Registered Under Section 12(b) of the Act:

$0.001 Common Stock
(Title of Class)

Securities Registered Under Section 12(g) of the Act:

None

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) to the Exchange Act. [ ]

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES [X] NO [ ]

Check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part II of this Form 10-K or any amendments to this Form 10-K. [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X].

The issuer's revenues for the ten months ended December 31, 2004: $15,674,613.

As of January 23, 2006, there were 32,967,183 shares of the registrant's common stock, $0.001 par value, outstanding. The aggregate market value of the common stock held by non-affiliates of the issuer was approximately 5,071,172 based on the closing price of $.18 per share on January 23, 2006, as reported by the American Stock Exchange.

Documents incorporated by reference: None

Transitional Small Business Disclosure Format (Check one): Yes [X]; No [ ]

EXPLANATORY NOTE (NEED TO REVISE TO ADD CHANGE TO LEGAL PROCEEDING ITEM)

The purpose of this Amendment No. 2 to Annual Report on Form 10-KSB/A of City Network, Inc. (the "Company," "we" or "our") for the fiscal period ended December 31, 2004, filed with the Securities and Exchange Commission ("SEC") on April 15, 2005 is to provide additional disclosure about the Company's ongoing legal proceedings. The only Items amended and restated herein are Part 1, Item 3 and Part II, Item 7.

Except as otherwise expressly noted herein, this Amendment No. 2 to the Annual Report on Form 10-KSB/A does not reflect events occurring after the April 15, 2005 filing of our Annual Report on Form 10-KSB in any way. The remaining Items contained within this Amendment No. 2 to our Annual Report on Form 10-KSB/A consist of all other Items originally contained in our Annual Report on Form 10-KSB and Form 10-KSB/A for the fiscal period ended December 31, 2004 in the form filed with the SEC on April 15, 2005 and July 6, 2005, respectively. These remaining Items are not amended hereby and are not included herein. In order to preserve the nature and character of the disclosures set forth in such Items as originally filed, except as expressly noted herein, this report continues to speak as of the date of the original filing, and we have not updated the disclosures in this report to speak as of a later date.

ITEM 3. LEGAL PROCEEDINGS

HWA-CHING CO. AND RELATED LAWSUITS

In April 2004, Hwa-Ching Co. made purchases from City Network Inc.-Taiwan for products in the aggregate amount of approximately NT$19 million or US$575,757. In June 2004, Hwa-Ching Co. wrote a check to City Network Inc.-Taiwan paying for such products and City Network Inc.-Taiwan successfully cashed this check. Also in June 2004, Hwa-Ching Co. made purchases from City Network Inc.-Taiwan for additional products in the aggregate amount of approximately NT$18 million or US$545,454 and paid for such products with a check that City Network Inc.-Taiwan also successfully cashed.

During June to August 2004, Hwa-Ching Co. requested additional products from City Network Inc.-Taiwan in the aggregate amount of approximately NT$27 million or US$818,181. City Network Inc.-Taiwan filled these orders with confidence as Hwa-Ching had paid for the prior orders from April 2004 and June 2004. However, the check, in the amount of approximately NT$27 million or US$818,181 that Hwa-Ching Co. wrote to City Network, Inc.-Taiwan bounced upon deposit with the bank. Immediately thereafter, Hwa-Ching Co. closed down with this remaining account payable balance of approximately NT$27 million or US$818,181 outstanding and payable to City Network Inc.-Taiwan.

In August 2004, City Network Inc.-Taiwan filed a lawsuit against Yune-Chang Tsuo, the owner of Hwa-Ching Co., as well as the following eight individuals including, Yong-Zhang Zhuo, Shu-Tao Lu, Yong-Yi Zhuo, Zhuan-Xuan Dai, Ya-Hui Qiu, Mei-Zhen Huang, Zong-Ya Wu, Yao-Guo Cen in Taiwan Taipei district court of Taiwan, in Taipei, Taiwan, alleging fraud for closing down Hwa-Ching Co. without payment for the delivered merchandise. City Network Inc.-Taiwan sought approximately NT$27 million or approximately US$900,000 from Yune-Chang Tsuo to cover the outstanding account payable. To date, the court has not yet reached a verdict on this case.

RPPI INTERNATIONAL LTD.

On October 10, 2004, Rong-Dian filed a lawsuit against City Network Inc.-Taiwan in the Taiwan Taipei district court of Taiwan, in Taipei, Taiwan, alleging breach of contract for two different purchase agreements that City Network Inc.-Taiwan entered with them and two third-parties. Rong-Dian sought the aggregate amount of approximately NT$40.2 million or US$1.2 million for the alleged breaches. One purchase agreement was for an order that City Network Inc.-Taiwan sold to Hwa-Ching Co. in the amount of approximately NT$27.3 million or US$900,000 and the other purchase agreement was for an order City Network Inc.-Taiwan sold to a separate customer of the Company in the amount of approximately NT$12.9 million or US$390,909. As of the date of this Report, the Company had not entered into a settlement agreement.

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ITEM 7. FINANCIAL STATEMENTS

Our Financial Statements together with the independent auditor's report thereon are included on pages F-1 through F-20 hereof.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this Form 10-KSB/A.

1. The following financial statements of our company, with the independent auditor's report, are filed as part of this Form 10-KSB/A:

2. The following exhibits are filed with this report and incorporated by reference as set forth below:

Exhibit	Description
2.1 (1)	Exchange Agreement dated December 4, 2002 by and among City Network, Inc., the shareholders of City Network, Inc., Investment Agents, Inc., Pamela Ray Stinson, Raymond Robert Acha, and Joseph H. Panganiban
3.1 (2)	Articles of Incorporation
3.2 (2)	Certificate of Amendment to Articles of Incorporation
3.3 (3)	Certificate of Amendment of the Articles of Incorporation
3.4 (4)	Amended and Restated Bylaws
14.1 (5)	Code of Ethics
21.1 (4)	Subsidiaries
31.1	Certification of Chief Executive Officer Pursuant to Section

302 of the Sarbanes-Oxley Act of 2002.

31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(1) Previously filed with the SEC as an Exhibit to City Network's Form 8-K filed March 5, 2003, and incorporated herein by reference.
(2) Previously filed with the SEC as an Exhibit to City Network's Form SB-2 filed May 18, 2001, and incorporated herein by reference.
(3) Previously filed with the SEC as an Exhibit to City Network's Proxy Statement filed March 21, 2003, and incorporated herein by reference.
(4) Previously filed with the SEC as an Exhibit to City Network's Annual Report on Form 10-KSB filed April 15, 2005, and incorporated herein by reference.
(5) Previously filed with the SEC as an Exhibit to City Network's Annual Report on Form 10-KSB filed June 16, 2003, and incorporated herein by reference.

(b) Current Reports on Form 8-K.

Report on Form 8-K filed December 20, 2004 announcing the appointment of Yung-Yi Tseng as CFO and director of our company and Chung-Chieh "Kevin" Lin, Yong Su, and Pi-Liang Liu as directors of our company.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CITY NETWORK, INC.

Date: January 27, 2006 By: /s/ Tiao-Tsan Lai

Tiao-Tsan Lai
Chief Executive Officer

Date: January 27, 2006 By: /s/ Yun-Yi Tseng

Yun-Yi Tseng
Chief Financial Officer

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CITY NETWORK, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

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LICHTER, YU AND ASSOCIATES
Certified Public Accountants

9191 Towne Centre Drive, Suite 406
San Diego, CA 92122
(858) 320-2808

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Stockholders of City Network, Inc.

We have audited the accompanying balance sheets of City Network, Inc. (the "Company") as of December 31, 2004 and February 29, 2004, and the related statements of income, stockholders' equity, and cash flows for the ten months ended December 31, 2004 and the year ended February 29, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of City Network, Inc. as of December 31, 2004 and February 29, 2004, and the results of its operations and its cash flows for ten months ended December 31, 2004 and the year ended February 29, 2004 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note O to the financial statements, the Company has restated its financial statements to include disclosures regarding certain legal proceedings. There is no effect on net income.

/s/ Lichter, Yu & Associates

March 7, 2005, except for Note O, as to which the date is December 7, 2005
San Diego, California

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CITY NETWORK, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

	December 31, 2004	February 29, 20
ASSETS		
Current Assets		
Cash and cash equivalents	$ 2,010,644	$ 2,723,573
Accounts receivable, net	3,333,990	7,173,149
Inventory	732,027	910,190
Other receivables	6,863	126,492
Prepaid expenses	102,896	557,903
Total Current Assets	6,186,420	11,491,307
Fixed Assets, net	2,586,872	2,745,664
Total Fixed Assets	2,586,872	2,745,664
Other Assets		
Deposits	1,724,542	255,706
Trademarks	1,812	1,966
Equity in net assets of affiliated company	829,008	770,678
Intangible assets	961,053	1,000,000
Other current assets	8,255	96
Total Other Assets	3,524,670	2,028,446
Total Assets	$ 12,297,962	$ 16,265,417
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable and accrued expenses	$ 3,335,286	$ 6,838,620
Due to related party	80,083	334,812
Loan payable	0	1,680,329
Deferred revenue	14,566	260,498
Deposits payable	0	4,371
Current portion, long-term debt	3,226,181	2,316,689
Total Current Liabilities	6,656,116	11,435,319
Long-term debt, net of current portion	246,330	263,041
Total Liabilities	6,902,446	11,698,360
Stockholders' Equity		
Common stock, $.001 par value, 100,000,000 shares authorized, 27,500,000 and 25,000,000 issued and outstanding, respectively	27,500	25,000
Additional paid in capital	5,937,946	4,260,117

Cumulative foreign-exchange translation adjustment	142,453	29,663
Retained earnings	(712,383)	252,277
Total Stockholders' Equity	5,395,516	4,567,057
Total Liabilities and Stockholders' Equity	$ 12,297,962	$ 16,265,417

See Accompanying Notes and Auditor's Report

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CITY NETWORK, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
TEN MONTHS ENDED DECEMBER 31, 2004 AND FISCAL YEAR ENDED FEBRUARY 29, 2004

	December 31, 2004	February 29, 20
Sales, net	$ 15,674,613	$ 19,647,749
Cost of sales	14,924,938	17,827,486
Gross profit	749,675	1,820,263
General and administrative expenses	1,395,388	1,391,658
Income (loss) from operations	(645,713)	428,605
Other (Income) Expense		
Interest income	(3,785)	(20,202)
Rental income	(17,858)	(3,085)
Commission income	(281)	(15,517)
(Gain) loss on currency exchange	(10,720)	(13,815)
Other income	(32,120)	(11,263)
Equity in earnings of investee	(58,330)	1,674
Miscellaneous	1,303	2,499
Bad debt expense	185,858	159,238
Loss on sale of fixed assets	32,068	0
Interest expense	112,922	67,691
Total Other (Income) Expense	209,057	167,220
Income (loss) before income taxes	(854,770)	261,385
Provison for income taxes	109,890	85,190
Net income (loss)	$ (964,660)	$ 176,195
Net income (loss) per share (basic and diluted)		
Basic	$ (0.036)	$ 0.007
Diluted	$ (0.036)	$ 0.007
Weighted average number of shares		
Basic	27,000,000	24,958,333

Diluted	27,000,000	24,958,333

See Accompanying Notes and Auditor's Report

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CITY NETWORK, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
TEN MONTHS ENDED DECEMBER 31, 2004 AND FISCAL YEAR ENDED FEBRUARY 29, 2004

	December 31, 2004	February 29, 2
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income (loss)	$ (964,660)	$ 176,195
Adjustments to reconcile net income (loss) to net cash provided by (used) in operating activities:		
Depreciation and amortization	161,296	44,057
Equity in earning of investee	(58,330)	1,674
Loss on disposal of assets	32,068	0
Bad debt	185,858	159,238
(Gain) loss on foreign currency exchange	(10,720)	(13,815)
Decrease (Increase) in receivables	3,839,159	(5,652,808)
Decrease (Increase) in inventory	178,163	(543,184)
Decrease (Increase) in other receivables	119,629	(115,032)
Decrease (Increase) in prepaid expenses	455,007	(347,946)
Decrease (Increase) in deposit	(1,468,836)	(254,737)
Decrease (Increase) in deferred charges	0	36,836
Decrease (Increase) in other current assets	(8,159)	72,662
(Decrease) Increase in accounts payable and accrued expenses	(3,503,334)	6,297,694
(Decrease) Increase in deferred revenue	(245,932)	260,498
(Decrease) Increase in deposits payable	(4,371)	4,371
Total Adjustments	(328,502)	(50,492)
Net cash provided by (used in) operations	(1,293,162)	125,703
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sale of investments	0	108,594
Proceeds from sale of fixed assets	35,462	0
Purchase of intangibles	0	(838)
Purchase of investments	0	(772,352)
Purchase of furniture and equipment	(5,008)	(462,722)
Net cash used in investing activities	30,454	(1,235,912)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payment on notes payable	(5,217,702)	(2,229,705)
Payment of loan from related party	(455,227)	0
Loan from related party	200,498	743,386
Issuance of notes payable	477,953	3,974,994
Issuance of short-term debt	5,621,631	0
Issuance of common stock	0	720,000
Net cash provided by financing activities	627,153	3,208,675

Effect of exchange rate change on cash	(77,374)	4,843
Net change in cash and cash equivalents	(712,929)	2,103,309
Cash and cash equivalents at beginning of year	2,723,573	620,264
Cash and cash equivalents at end of year	$ 2,010,644	$ 2,723,573
Supplemental cash flows disclosures:		
Income tax payments	$ 35,750	$ 9,235
Interest payments	$ 112,922	$ 67,691
Non cash transaction:		
Conversion of debt to equity	$ 1,680,329	$ 0

See Accompanying Notes and Auditor's Report

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CITY NETWORK, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
TEN MONTHS ENDED DECEMBER 31, 2004 AND FISCAL YEAR ENDED FEBRUARY 29, 2004

	December 31, 2004	February 29
Common stock, number of shares outstanding		
Balance at beginning of period	25,000,000	24,500,
Stock cancellation	0	
Stock split	0	
Common stock issued	2,500,000	500,
Balance at end of period	27,500,000	25,000,
Common stock, par value $.001 (thousands of shares)		
Balance at beginning of year	$ 25,000	$ 24,
Stock cancellation	0	
Stock split	0	
Common stock issued	2,500	
Balance at end of year	27,500	25,
Additional paid in capital		
Balance at beginning of year	4,260,117	3,540,
Issuance of stock	1,677,829	719,
Balance at end of year	5,937,946	4,260,
Cumulative foreign-exchange translation adjustment		
Balance at beginning of year	29,663	
Foreign currency translation	123,689	29,
Balance at end of year	153,352	29,
Retained (deficits)		

Balance at beginning of year	252,277	76,
Issuance of stock dividend	0	
Net income (loss)	(964,660)	176,
Balance at end of year	(712,383)	252,
Total stockholders' equity at end of year	$ 5,406,415	$ 4,567,

See Accompanying Notes and Auditor's Report

CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

Note A - ORGANIZATION

City Network, Inc., formerly Investment Agents, Inc., was incorporated on August 8, 1996 under the laws of the State of Nevada. City Network Technology, Inc., formerly Gelcrest Investments Limited, was incorporated under the laws of the British Virgin Islands on March 1, 2002. City Network, Inc. -Taiwan, formerly City Engineering, Inc., was incorporated under the laws of Republic of China on September 6, 1994. City Construction was incorporated under the laws of Republic of China on October, 10, 2003. City Network, Inc. owns 100% of the capital stock of City Network Technology, Inc., and City Network Technology, Inc. owns 100% of the capital stock of City Network, Inc. - Taiwan, and City Construction. Collectively the four corporations are referred to herein as the "Company".

On November 14, 2002, City Network Technology, Inc. became a wholly owned subsidiary of City Network, Inc. through an Exchange Agreement, which was amended on December 4, 2002 whereby City Network, Inc. acquired all of the issued and outstanding capital stock of City Network Technology, Inc. in exchange for 12,000,000 shares of City Network, Inc.

The Company is a provider of internet broadband and wireless infrastructure equipment and service for the rapidly expanding broadband marketplace. The Company intends to be an important provider of these services predicated upon its dedication to delivering user friendly, cost effective, and customer tailored high speed internet access equipment to meet the business needs of the hospitality, residential property and telecommunication industry worldwide.

On December 16, 2004, the Company changed its fiscal year end from February 28 to December 31.

CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

Note B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

REVENUE RECOGNITION
Revenue from sales of products to customers is recognized upon shipment or

when title passes to customers based on the terms of the sales, and is recorded net of returns, discounts and allowances. Service income is recognized as the related services are provided pursuant to the terms of the service agreement.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of City Network, Inc., and its wholly owned subsidiaries City Network Technology, Inc. and its wholly owned subsidiaries, City Network, Inc. - Taiwan and City Construction, collectively referred to within as the Company. All material intercompany accounts, transactions and profits have been eliminated in consolidation.

RISKS AND UNCERTAINTIES

The Company is subject to substantial risks from, among other things, intense competition from the providers of broadband products, services and the telecommunication industry in general, other risks associated with financing, liquidity requirements, rapidly changing customer requirements, limited operating history, and the volatility of public markets.

CONTINGENCIES

Certain conditions may exist as of the date the financial statements are issued, which may result in a loss to the Company but which will only be resolved when one or more future events occur or fail to occur. The Company's management and legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are pending against the Company or unasserted claims that may result in such proceedings, the Company's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims as well as the perceived merits of the amount of relief sought or expected to be sought.

If the assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability would be accrued in the Company's financial statements. If the assessment indicates that a potential material loss contingency is not probable but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material would be disclosed.

Loss contingencies considered to be remote by management are generally not disclosed unless they involve guarantees, in which case the guarantee would be disclosed.

Note B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include collectibility of accounts receivable, accounts payable, sales returns and recoverability of long-term assets.

ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company has made an allowance for doubtful accounts for trade receivables based on a combination of write-off history, aging analysis, and any specific known troubled accounts.

FIXED ASSETS

Property and equipment are stated at cost less accumulated depreciation. Expenditures for major additions and improvements are capitalized and minor replacements, maintenance and repairs are charged to expense as incurred. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, or the remaining term of the lease, as follows:

Furniture and Fixtures	5 years
Equipment	5 years
Computer Hardware and Software	3 years
Building and Improvements	50 years

INTANGIBLE ASSETS

Effective July 2002, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets." The adoption of SFAS No. 142 required an initial impairment assessment involving a comparison of the fair value of trademarks, patents and other intangible assets to current carrying value. No impairment loss was recognized for the years ended December 31, 2004 and February 29, 2004.

Trademarks and other intangible assets determined to have indefinite useful lives are not amortized. The Company tests such trademarks and other intangible assets with indefinite useful lives for impairment annually, or more frequently if events or circumstances indicate that an asset might be impaired. Trademarks and other intangible assets determined to have definite lives are amortized over their useful lives or the life of the trademark and other intangible asset, whichever is less.

EXCHANGE GAIN (LOSS)

During year ended December 31, 2004 and February 29, 2004, the transactions of City Network, Inc. - Taiwan and City Construction were denominated in a foreign currency and are recorded in New Taiwan dollars at the rates of exchange in effect when the transactions occur. Exchange gains and losses are recognized for the different foreign exchange rates applied when the foreign currency assets and liabilities are settled.

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CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

Note B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

TRANSLATION ADJUSTMENT

As of December 31, 2004 and February 29, 2004, the accounts of City Network, Inc. - Taiwan and City Construction were maintained, and their financial statements were expressed, in New Taiwan Dollars (NTD). Such financial statements were translated into U.S. Dollars (USD) in accordance SFAS No. 52, "Foreign Currency Translation", with the NTD as the functional currency. According to the Statement, all assets and liabilities were translated at the current exchange rate, stockholder's equity are translated at the historical rates and income statement items are translated at the weighted average exchange rate for the period. The resulting translation adjustments are reported under other comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income".

As of December 31, 2004 and February 29, 2004 the exchange rates between NTD and the USD was NTD$1=USD$0.03128 and NTD$1=USD$0.02994, respectively. The weighted-average rate of exchange between NTD and USD was NTD$1=USD$0.02998 and NTD$1=USD$0.02617, respectively. Total translation adjustment recognized for the year ended December 31, 2004 and February 29, 2004 is $153,352 and $29,663, respectively.

FAIR VALUE OF FINANCIAL INSTRUMENTS
Our Company measures its financial assets and liabilities in accordance with generally accepted accounting principles. For certain of the Company's financial instruments, including accounts receivable (trade and related party), notes receivable and accounts payable (trade and related party), and accrued expenses, the carrying amounts approximate fair value due to their short maturities. The amounts owed for long-term debt and revolving credit facility also approximate fair value because interest rates and terms offered to the Company are at current market rates.

STATEMENT OF CASH FLOWS
In accordance with SFAS No. 95, "Statement of Cash Flows", cash flows from the Company's operations are based upon the local currencies. As a result, amounts related to assets and liabilities reported on the statement of cash flows will not necessarily agree with changes in the corresponding balances on the balance sheet.

CONCENTRATION OF CREDIT RISK
Financial instruments that potentially subject the Company to concentrations of credit risk are accounts receivable and other receivables arising from its normal business activities. The Company has a diversified customer base. The Company controls credit risk related to accounts receivable through credit approvals, credit limits and monitoring procedures. The Company routinely assesses the financial strength of its customers and, based upon factors surrounding the credit risk, establishes an allowance, if required, for un-collectible accounts and, as a consequence, believes that its accounts receivable credit risk exposure beyond such allowance is limited.

Note B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

INVENTORY
Inventory is valued at the lower of cost or market. Cost is determined on the weighted average method. As of December 31, 2004 and February 29, 2004, inventory consisted only of finished goods.

PRODUCT WARRANTIES
The Company estimates its warranty costs based on historical warranty claim experience and applies this estimate to the revenue stream for products under warranty. Future costs for warranties applicable to revenue recognized in the current period are charged to cost of revenue. The warranty accrual is reviewed quarterly to verify that it properly reflects the remaining obligation based on anticipated expenditures over the balance of the obligation period. Adjustments are made when accrual warranty claim

experience differs from estimate.

LONG-TERM EQUITY INVESTMENTS
Long-term equity investments are accounted for by the equity method when the Company and its subsidiaries owns 20% or more of the investee's voting shares, or less than 20% of investee's voting shares but is able to exercise significant influence over the investee's operation and financial polices, but not more then 50%. All other long-term equity investments are accounted for by either the lower-of-cost-or-market method or cost method. For long-term equity investments accounted for under the equity method related to investee's that are publicly listed companies, unrealized losses resulting from declines in the market value below cost are recorded as a separate component of stockholders' equity.

For long-term equity investments in non-listed companies accounted for under the cost method, investments are stated at original cost. A write-down of the investment balance to earnings is taken only if it is determined that there is a permanent decline in the investment's value. Stock dividends do not result in the recognition of investment income.

For long-term equity investments accounted for by the equity method, the investment is initially recorded at cost, then reduced by dividends and increased or decreased by investor's proportionate share of the investee's net earnings or loss.

CASH AND CASH EQUIVALENTS
The Company considers all highly liquid investments purchased with initial maturities of three months or less to be cash equivalents.

ADVERTISING
Advertising costs are expensed in the year incurred.

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CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

Note B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

INCOME TAXES
Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements.

Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in SFAS No. 109, "Accounting for Income Taxes". As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

EARNINGS PER SHARE
The Company uses SFAS No. 128, "Earnings Per Share", for calculating the basic and diluted earnings (loss) per share. Basic earnings (loss) per share are computed by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares outstanding. Diluted earnings per share are computed similar to basic earnings per share except that the denominator is increased to include common stock

equivalents, if any, as if the potential common shares had been issued.

IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF
The Company adopted the provision of The Financial Accounting Standards Board ("FASB") No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of". This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amounts of the assets exceed the fair values of the assets. In assessing the impairment of these identifiable intangible assets, identifiable goodwill will be allocated on a pro rata basis using fair values of the assets at the original acquisition date. In estimating expected future cash flows for determining whether an asset is impaired and if expected future cash flows are used in measuring assets that are impaired, assets will be grouped at the lowest level (entity level) for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. In recording an impairment loss, any related goodwill would be reduced to zero before reducing the carrying amount of any identified impaired asset.

For goodwill not identifiable with an impaired asset, the Company will establish benchmarks at the lowest lever (entity level) as its method of assessing impairment. In measuring impairment, unidentifiable goodwill will be considered impaired if the fair value at the lowest level is less than its carrying amount. The fair value of unidentifiable goodwill will be determined by subtracting the fair value of the recognized net asset at the lowest level (excluding goodwill) from the value at the lowest level. The amount of the impairment loss should be equal to the difference between the carrying amount of goodwill and the fair value of goodwill. In the event that impairment is recognized, appropriate disclosures would be made.

Note B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

NEW ACCOUNTING PRONOUNCEMENTS
In January 2003, FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN46"). This interpretation of Accounting Research Bulletin No. 51, requires companies to consolidate the operations of all variable interest entities ("VIE's") for which they are the primary beneficiary. The term "primary beneficiary" is defined as the entity that will absorb a majority of expected losses, receive a majority of the expected residual returns, or both. This interpretation was later revised by the issuance of Interpretation No. 46R ("FIN 46R"). The revision was issued to address certain implementation issues that had arisen since the issuance of the original interpretation and to provide companies with the ability to defer the adoption of FIN46 to period after March 15, 2004. The implementation of FIN46 and FIN 46R, had no material impact on the Company's financial statements.

On July 16, 2004 the FASB ratified the Emerging Issues Task Force ("EITF") consensus of Issue 02-14, "Whether the Equity Method of Accounting Applies when an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means" ("EITF 02-14"). The consensus concluded that an investor should apply the equity method of accounting when it can exercise significant influence over an entity through a means other than holding voting rights. The consensus is effective for reporting periods beginning after September 2004. The adoption of EITF 02-14 did not have a material impact on the Company's financial statements.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), which replaces SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") and supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first interim or annual period after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS 123R in its three months ending September 30, 2005. Under SFAS 123R, The Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The Company is evaluating the requirements of SFAS 123, and it expects that the adoption of SFAS 123R will have no material impact on the Company's financial statements.

In September 2004, the EITF Issue No. 04-08, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share" ("EITF 04-08") was issued stating that contingently convertible debt should be included in diluted earnings per share computations regardless of whether the market price trigger has been met. EIFT 04-08 is effective for reporting periods ending after December 15, 2004. EITF 04-08 will have no material impact on the Company's financial statements.

Note D -CASH

The Company maintains its cash balances at various banks in Taiwan and Hong Kong. All balances are insured by the Central Deposit Insurance Corporation (CDIC). As of December 31, 2004 and February 29, 2004, there were no uninsured portions of the balances held at the bank.

Note E - FIXED ASSETS

Fixed assets consist of the following:

	December 31, 2004	February 29, 2004

Land	$ 1,916,328	$ 1,966,694
Building	283,977	305,429
Machinery and equipment	430,880	427,126
Furniture and fixtures	143,655	142,402
	$ 2,774,840	$ 2,841,651
Accumulated depreciation	(187,968)	(95,987)
	$ 2,586,872	$ 2,745,664

Note F - INTANGIBLE ASSETS

Intangible assets consist of the following:

	December 31, 2004	February 29, 2004
Trademarks	$ 2,150	$ 2,150
Intangible asset	1,000,000	1,000,000
	$ 1,002,150	$ 1,002,150
Accumulated depreciation	(39,285)	(184)
	$ 962,865	$ 1,001,966

Note G- COMMITTMENTS

A BEST INFORMATION

City Network, Inc. - Taiwan, signed an agreement with A Best Information in 2003 for the exclusive right to sell A Best Information's products. There is no expiration date in the agreement, and the Company has the rights to transfer the agreement to any third party with a negotiable price. The Company paid $1,000,000 for these rights.

RESELLER AGREEMENTS

City Network, Inc. - Taiwan has several signed reseller agreements with various customers. These resellers are given special sales prices and are paid commissions for their sales orders.

CO-CONSTRUCTION AGREEMENT

In April 2004, City Construction Co., Ltd. Entered into a Co-Construction Agreement with another company in Taipei, Taiwan. Under the Agreement, the Company will finance, construct and own 50% of the building project. The Company has not yet begun construction on the building.

OPERATING LEASES

The Company leases various office facilities under operating leases that terminate on various dates. Rental expense for these leases consisted of $50,029 for the ten months ended December 31, 2004 and $13,482 for the year ended February 29, 2004. The Company has future minimum lease obligations as follows:

2005	$20,122

Note H - LONG-TERM INVESTMENT

BEIJING PUTAIN HEXIN NETWORK TECHNOLOGY CO., LTD
On August 31, 2003 the Company purchased approximately twenty-five percent (25%) of Beijing Putain Hexin Network Technology Co., Ltd for $325,000. On December 4, 2003 the Company purchased an additional fifteen percent (15%) for $398,500. Beijing Putain Hexin Network Technology Co., Ltd is not publicly traded or listed. The Company is using the complete equity method to record its share of the subsidiary's net income and loss. As of December 31, 2004 and February 29, 2004 the Company recognized an income of $58,330 and a loss $1,674 from their acquisition.

CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

Note I - COMPENSATED ABSENSES

Employees earn annual vacation leave at the rate of seven (7) days per year for the first three years. Upon completion of the third year of employment, employees earn annual vacation leave at the rate of ten (10) days per year for years four through five. Upon completion of the fifth year of employment, employees earn annual vacation leave at the rate of fourteen (14) days per year for years six through ten. Upon completion of the tenth year of employment, one (1) additional day for each additional year, until it reaches thirty (30) days per year. At termination, employees are paid for any accumulated annual vacation leave. As of December 31, 2004 and February 29, 2004 vacation liability existed in the amount of $1,892 and $0 respectively.

Note J - INCOME TAXES

Total Federal and State income tax expense for the years ended December 31, 2004 and February 29, 2004 amounted to $109,890 and $85,190, respectively. For the years ended December 31, 2004 and February 29, 2004, there is no difference between the federal statutory tax rate and the effective tax rate.

The following is a reconciliation of income tax expense:

12/31/04	U.S.	State	International	Total
Current	$ 0	$ 0	$109,890	$109,890
Deferred	0	0	0	0
Total	$ 0	$ 0	$109,890	$109,890

02/29/04	U.S.	State	International	Total
Current	$ 3,321	$ 0	$ 44,180	$ 47,501

Deferred	0	0	0	0
Total	$ 3,321	$ 0	$ 44,180	$ 47,501

Reconciliation of the differences between the statutory U.S. Federal income tax rate and the effective rate is as follows:

	12/31/2004	2/29/2004
Federal statutory tax rate	33%	33%
State, net of federal benefit	0%	0%
Effective tax rate	33%	33%

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CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

NOTE K - DEBT

At December 31, 2004 and February 29, 2004, the Company had notes payable outstanding in the aggregate amount of $3,461,162 and $2,579,730, respectively. Payable as follows:

December 31, 2004		February 29, 2004
Secured note payable to a bank in Taiwan, interest at 3.175% per annum, due by May 29, 2016	$280,689	Secured note payable to a bank Taiwan, interest at 3.175% per ann due by May 29, 2016
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by October 8, 2005	500,480	Secured note payable to a bank Taiwan, interest at 7.425% per ann due by May 9, 2004
Note payable to a bank in Taiwan, interest at 3.828% per annum, due by February 13, 2005	125,120	Secured note payable to a bank Taiwan, interest at 4.25% per ann due by June 6, 2005
Note payable to a bank in Taiwan, interest at 4.42% per annum, due by March 29, 2005	246,921	Note payable to a bank in Taiw interest at 4.25% per annum, due June 12, 2005
Note payable to a bank in Taiwan, interest at 4.42% per annum, due by March 15, 2005	68,004	Note payable to a bank in Taiw interest at 7.5% per annum, due by J 16, 2004
Note payable to a bank in Taiwan, interest at 4.42% per annum, due by April 11, 2005	76,548	Note payable to a bank in Taiw interest at 3.77% per annum, due December 31, 2004
Note payable to a bank in Taiwan, interest at 4.42% per annum, due by April 10, 2005	54,995	Note payable to a bank in Taiw interest at 3.77% per annum, due March 13, 2004

Note payable to a bank in Taiwan, interest at 4.42% per annum, due by May 29, 2005	233,493	Note payable to a bank in Taiw interest at 3.77% per annum, due March 26, 2004
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 10, 2005	196,563	Note payable to a bank in Taiw interest at 3.77% per annum, due by 4, 2004
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by February 15, 2005	60,761	Note payable to a bank in Taiw interest at 3.77% per annum, due March 5, 2004

CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

NOTE K - DEBT (CONTINUED)

Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 8, 2005	141,511	Note payable to a bank in Taiw interest at 3.77% per annum, due April 8, 2004
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 2, 2005	35,121	Note payable to a bank in Taiw interest at 3.77% per annum, due April 23, 2004
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 15, 2005	43,498	Note payable to a bank in Taiw interest at 3.77% per annum, due April 8, 2004
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 11, 2005	13,085	Note payable to a bank in Taiw interest at 3.77% per annum, due April 8, 2004
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by April 9, 2005	591,192	Note payable to a bank in Taiw interest at 4.269% per annum, due August 25, 2004
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by April 9, 2005	53,895	
Note payable to a bank in Taiwan, interest at 3.616% per annum, due by April 9, 2005	59,521	
Note payable to a bank in Taiwan, interest at 3.26% per annum, due by March 11, 2005	312,752	
Note payable to a bank in Taiwan, interest at 3.26% per annum, due by April 22, 2005	121,866	
Note payable to a corporation in		

Taiwan, interest at 6.265% per annum, due by November 20, 2005, personally guaranteed by an office of the Company	256,496
Total	3,461,612
Current portion	$3,215,282
Long-term portion	$ 246,330

CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

NOTE L - RELATED PARTY TRANSACTIONS

Throughout the history of the Company, certain members of the Board of Directors and general management have made loans to the Company to cover operating expenses or operating deficiencies.

Andy Lai - As of December 31, 2004 and February 29, 2004, the Company has a non interest-bearing loan from Andy Lai, the Company's President, in the amount of $73,827 and $334,812, respectively. Mr. Lai has also personally guaranteed a note payable of the Company in the amount of $477,953. As of December 31, 2004, the balance for the note was $256,496.

Huang Hui Maio - As of December 31, 2004, the Company has a non interest-bearing loan from Huang Hui Maio, a shareholder of the Company, in the amount of $6,256.

NOTE M - FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of cash and cash equivalents, accounts receivable, deposits and accounts payable approximate their fair value because of the short maturity of those instruments.

The carrying amounts of the Company's long-term debt approximate their fair value because of the short maturity and/or interest rates which are comparable to those currently available to the Company on obligations with similar terms.

NOTE N - STOCK

On February 14, 2003 the Board of Directors of the Company approved and recommended that Company's Articles of Incorporation be amended to increase the number of authorized shares of common stock, par value $0.001 of the Company, from 25,000,000 shares to 100,000,000; and to authorize 50,000,000 shares of preferred stock, par value $0.001.

On February 17, 2003, the holders of approximately 52% of the outstanding shares of common stock of City Network executed a written consent adopting and approving the Charter Amendment. The Charter Amendment was filed with the Secretary of State of the State of Nevada in March 2003.

In May 2004, the Company issued 2,500,000 shares of its common stock as consideration for the conversion in full of a note and short term debt payable to third parties in the aggregate of $1,680,329. The note and short term debt payable were converted into shares of common stock at a price of approximately $0.672 per share.

Note O - LEGAL PROCEEDINGS

The Company is party to certain litigation that has arisen in the normal course of its business and that of its subsidiary.

HWA-CHING - In August 2004, a customer closed business and did not pay the remaining balance due to City Network - Taiwan on outstanding receivables in the amount of $880,649. City Network - Taiwan has filed criminal and civil litigation against the customer for fraud. This case is currently ongoing.

In August 2004, City Network Inc.-Taiwan filed a lawsuit against the owner of Hwa-Ching Co., as well as eight individuals in Taiwan, alleging fraud for closing down Hwa-Ching Co. without payment for the delivered merchandise. City Network Inc.-Taiwan sought approximately NT$27 million or approximately US$900,000. To date, the court has not yet reached a verdict on this case.

In December 2004, the Company filed a lawsuit against Tain-Kang Co., a customer of Hwa-Ching Co. in Taipei District Court claiming damages owed to Hwa-Ching from Tain-Kang in the amount of approximately NT$5,796,000 or US$172,963 to cover the outstanding account payable owed by Hwa-Ching to the Company. To date, the court has not yet reached a verdict on this case.

RPPI INTERNATIONAL LTD. - On October 10, 2004, Rong-Dian filed a lawsuit against City Network Inc.-Taiwan in the Taiwan Taipei district court of Taiwan, in Taipei, Taiwan, alleging breach of contract for two different purchase agreements that City Network Inc.-Taiwan entered with them and two third-parties. Rong-Dian sought the aggregate amount of approximately NT$40.2 million or US$1.2 million for the alleged breaches. One purchase agreement was for an order that City Network Inc.-Taiwan sold to Hwa-Ching Co. in the amount of approximately NT$27.3 million or US$900,000 and the other purchase agreement was for an order City Network Inc.-Taiwan sold to a separate customer of the Company in the amount of approximately NT$12.9 million or US$390,909. As of the date of this Report, the Company had not entered into a settlement agreement.

SHANGHAI BANK - On January 24, 2005, Shanghai Commercial and Savings Bank ("Shanghai Bank") filed a lawsuit with the Taipei District Court against the Company claiming approximately NT$12 million or approximately US$387,000 for the payment of an unpaid purchase price for goods. The Company purchased such goods from Chin Shin and Chin Shin assigned the account receivable to Shanghai Bank. As such, Shanghai Bank sued the Company for the payment of those goods. However, the Company returned the said goods because they were defective. The Company and Shanghai Bank are currently in negotiations for a settlement agreement in this matter. The Company deposited a bond in the amount of approximately NT$3 million or approximately US$90,000 with the court at the commencement of the lawsuit.

CITY NETWORK, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2004 AND FEBRUARY 29, 2004

NOTE P - TRANSITION REPORTS

In accordance to Regulation 13A-10, the following table present the statements of income for the ten months ended December 31, 2004 and 2003 for the Company, due to the change in the fiscal year ended from February 28 to December 31.

	Ten months ended December 31, 2004	Ten months ended December 31, 2003
	(Audited)	(Unaudited)
Sales, net	$ 15,674,613	$ 16,119,649
Cost of sales	14,924,938	14,798,578
Gross profit	749,675.00	1,321,071
General and administrative expenses	1,395,388	758,032
Income (loss) from operations	(645,713)	563,039
Other (Income) Expense		
Interest income	(3,785)	(21,137)
Rental income	(17,858)	(2,093)
Commission income	(281)	(14,767)
(Gain) loss on currency exchange	(10,720)	(5,100)
Other income	(32,120)	(36,067)
Equity in earnings of investee	(58,330)	2,676
Miscellaneous	1,303	61,774
Bad debt expense	185,858	362,075
Loss on sale of fixed assets	32,068	0
Interest expense	112,922	55,655
Total Other (Income) Expense	209,057	403,016
Income (loss) before income taxes	(854,770)	160,023
Provison for income taxes	109,890	137,095
Net income (loss)	($ 964,660)	$ 22,928
Net income (loss) per share (basic and diluted)		
Basic	$ (0.036)	$ 0.001
Diluted	$ (0.036)	$ 0.001
Weighted average number of shares		
Basic	27,000,000	24,777,778
Diluted	27,000,000	24,777,778

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Governmental National Mortgage Association securities

35,211 1,040 (96) 36,155

Total mortgage-backed securities

182,046 5,347 (105) 187,288

Obligations of states and political subdivisions

10,637 279 (12) 10,904

U.S. government agency securities

52,177 279 (22) 52,434

Corporate obligations

1,654 23 1,677

Total debt securities

246,514 5,928 (139) 252,303

Equity securities

12 26 38

Total

$246,526 $5,954 $(139) $252,341

Held to Maturity

Fannie Mae

$2,600 $140 $ $2,740

Freddie Mac

10,195 319 10,514

Total

$12,795 $459 $ $13,254

The amortized cost and fair value of debt securities at December 31, 2010, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands):

	Available For Sale		Held To Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 3	$ 3	$ 6	$ 6
Due after one year through five years	30,429	30,469	945	1,002
Due after five years through ten years	45,738	46,251	1,140	1,207
Due after ten years	171,712	172,691	9,338	9,438
Total	$ 247,882	$ 249,414	$ 11,429	$ 11,653

The Bank had no sales of investment securities for the three months ended December 31, 2010 or 2009.

7. Unrealized Losses on Securities

The following table shows the Company s gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position (in thousands):

	December 31, 2010						
		Less than Twelve Months		Twelve Months or Greater		Total	
	Number of Securities	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fannie Mae	20	$ 50,675	$ (1,587)	$	$	$ 50,675	$ (1,587)
Freddie Mac	4	9,765	(306)			9,765	(306)
Governmental National Mortgage Association securities	5	10,842	(65)			10,842	(65)
Obligations of states and political subdivisions	4	3,965	(119)			3,965	(119)
U.S. government agency securities	11	21,297	(224)			21,297	(224)
Total	44	$ 96,544	$ (2,301)	$	$	$ 96,544	$ (2,301)

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	September 30, 2010						
		Less than Twelve Months		Twelve Months or Greater		Total	
	Number of Securities	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fannie Mae	1	$ 2,060	$ (9)	$	$	$ 2,060	$ (9)
Governmental National Mortgage Association securities	2	5,605	(96)			5,605	(96)
Obligations of states and political subdivisions	1	610	(12)			610	(12)
U.S. government agency securities	4	6,484	(22)			6,484	(22)
Total	8	$ 14,759	$ (139)	$	$	$ 14,759	$ (139)

The Company s investment securities portfolio contains unrealized losses on securities, including mortgage-related instruments issued or backed by the full faith and credit of the United States government, or generally viewed as having the implied guarantee of the U.S. government, and debt obligations of a U.S. State or political subdivision.

The Company reviews its position quarterly and has asserted that at December 31, 2010, the declines outlined in the above table represent temporary declines and the Company would not be required to sell the security before its anticipated recovery in market value.

The Company has concluded that any impairment of its investment securities portfolio is not other than temporary but is the result of interest rate changes that are not expected to result in the noncollection of principal and interest during the period.

8. Loans Receivable, Net and Allowance for Loan Losses

Loans receivable consist of the following (in thousands):

	December 31, 2010	September 30, 2010
Real Estate Loans:		
Residential	$ 598,852	$ 596,170
Construction	1,755	1,302
Commercial	94,387	78,056
Commercial	15,496	16,569
Home equity loans and lines of credit	42,610	43,538
Other	2,231	2,486
	755,331	738,121
Plus deferred loan costs	229	169
	755,560	738,290
Less allowance for loan losses	7,738	7,448
Net loans	$ 747,822	$ 730,842

	Real Estate Loans						
	Residential	Construction	Commercial	Commercial Loans	Home Equity and Lines of Credit	Other Loans	Total
				(dollars in thousands)			
December 31, 2010							

Total Loans	$ 598,852	$ 1,755	$ 94,387	$ 15,496	$ 42,610	$ 2,231	$ 755,331
Individually evaluated for impairment	5,261		3,464	25	116		8,866
Collectively evaluated for impairment	593,591	1,755	90,923	15,471	42,494	2,231	746,465

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We maintain a loan review system, which allows for a periodic review of our loan portfolio and the early identification of potential impaired loans. Such system takes into consideration, among other things, delinquency status, size of loans, type and market value of collateral and financial condition of the borrowers. Specific loan loss allowances are established for identified losses based on a review of such information. A loan evaluated for impairment is considered to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. All loans identified as impaired are evaluated independently. We do not aggregate such loans for evaluation purposes. Impairment is measured on a loan-by-loan basis for commercial and construction loans by the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral-dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential mortgage loans for impairment disclosures, unless such loans are part of a larger relationship that is impaired, or are classified as a troubled debt restructuring.

A loan is considered to be a troubled debt restructuring (TDR) loan when the Company grants a concession to the borrower because of the borrower s financial condition that it would not otherwise consider. Such concessions include the reduction of interest rates, forgiveness of principal or interest, or other modifications of interest rates that are less than the current market rate for new obligations with similar risk. TDR loans that are in compliance with their modified terms and that yield a market rate may be removed from the TDR status after a period of performance.

The following table includes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable. Also presented are the average recorded investments in the impaired loans and the related amount of interest recognized during the time within the period that the impaired loans were impaired.

	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2010					
With no specific allowance recorded:					
Real Estate Loans					
Residential	$ 3,328	$ 3,321	$	$ 3,081	$ 60
Construction					
Commercial	2,254	2,254		2,398	23
Commercial	22	22		42	
Home equity loans and lines of credit	14	14		14	
Other					
Total	5,618	5,611		5,535	83
With an allowance recorded:					
Real Estate Loans					
Residential	1,940	1,940	239	1,996	
Construction					
Commercial	1,211	1,210	200	657	
Commercial	3	3	3	3	
Home equity loans and lines of credit	102	102	58	74	
Other					
Total	3,256	3,255	500	2,730	
Total:					
Real Estate Loans					
Residential	5,268	5,261	239	5,077	60
Construction					
Commercial	3,465	3,464	200	3,055	23

Commercial	25	25	3	45	
Home equity loans and lines of credit	116	116	58	88	
Other					
Total Impaired Loans	$ 8,874	$ 8,866	$ 500	$ 8,265	$ 83

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Management uses an eight point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first four categories are considered not criticized, and are aggregated as Pass rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are considered Substandard. The portion of any loan that represents a specific allocation of the allowance for loan losses is placed in the Doubtful category. Any portion of a loan that has been charged off is placed in the Loss category.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. The Bank s Commercial Loan Officers are responsible for the timely and accurate risk rating of the loans in their portfolios at origination and on an ongoing basis. The Bank s Commercial Loan Officers perform an annual review of all commercial relationships $250,000 or greater. Confirmation of the appropriate risk grade is included in the review on an ongoing basis. The Bank engages an external consultant to conduct loan reviews on at least a semi-annual basis. Generally, the external consultant reviews commercial relationships greater than $500,000 and/or all criticized relationships. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard on a quarterly basis. Loans in the Special Mention and Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system as of December 31, 2010 (in thousands):

	Pass	Special Mention	Substandard	Doubtful	Total
December 31, 2010					
Real estate loans					
Residential	$ 573,322	$ 8,158	$ 17,372	$	$ 598,852
Construction	1,755				1,755
Commercial	77,670	2,618	14,099		94,387
Commercial	15,107	271	118		15,496
Home equity loans and lines of credit	41,081	625	904		42,610
Other	2,136	5	90		2,231
Total	$ 711,071	$ 11,677	$ 32,583	$	$ 755,331

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of December 31, 2010 (in thousands):

	Current	31-60 Days Past Due	61-90 Days Past Due	Greater than 90 Days Past Due and still accruing	Non-Accrual	Total Past Due and Non-Accrual	Total Loans
December 31, 2010							
Real estate loans							
Residential	$ 584,270	$ 4,453	$ 749	$	$ 9,380	$ 14,582	$ 598,852
Construction	1,755						1,755
Commercial	92,276				2,111	2,111	94,387
Commercial	15,429	5			62	67	15,496
Home equity loans and lines of credit	42,149	204	77		180	461	42,610
Other	2,023	7	5		196	208	2,231

Total	$ 737,902	$	4,669	$	831	$		$	11,929	$	17,429	$ 755,331

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Nonperforming assets were $14.7 million at December 31, 2010. Nonperforming assets were $12.9 million at September 30, 2010. The increase was due to increases of $1.0 million in nonperforming residential loans, $564,000 in commercial loans and $359,000 in other real estate loans offset, in part, by a decrease of $170,000 in consumer loans. Commercial nonperforming loans increased primarily as a result of the addition of two commercial real estate relationships. Non-performing residential loans increased due to increases in outstanding balances of new non-performing residential loans. The number of non-performing residential loans remained unchanged from September 30, 2010 at 50 loans. Foreclosed real estate was $2.4 million at December 31, 2010 and $2.0 million at September 30, 2010.

Our allowance for loan losses is maintained at a level necessary to absorb loan losses that are both probable and reasonably estimable. Management, in determining the allowance for loan losses, considers the losses inherent in its loan portfolio and changes in the nature and volume of loan activities, along with the general economic and real estate market conditions. Our allowance for loan losses consists of two elements: (1) an allocated allowance, which comprises allowances established on specific loans and class allowances based on historical loss experience and current trends, and (2) an allocated allowance based on general economic conditions and other risk factors in our markets and portfolios. We maintain a loan review system, which allows for a periodic review of our loan portfolio and the early identification of potential impaired loans. Such system takes into consideration, among other things, delinquency status, size of loans, type and market value of collateral and financial condition of the borrowers. General loan loss allowances are based upon a combination of factors including, but not limited to, actual loan loss experience, composition of the loan portfolio, current economic conditions, management s judgment and losses which are probable and reasonably estimable. The allowance is increased through provisions charged against current earnings and recoveries of previously charged-off loans. Loans that are determined to be uncollectible are charged against the allowance. While management uses available information to recognize probable and reasonably estimable loan losses, future loss provisions may be necessary based on changing economic conditions. Payments received on impaired loans generally are either applied against principal or reported as interest income, according to management s judgment as to the collectability of principal. The allowance for loan losses as of December 31, 2010 is maintained at a level that represents management s best estimate of losses inherent in the loan portfolio, and such losses were both probable and reasonably estimable.

In addition, the Office of Thrift Supervision and the Pennsylvania Department of Banking, as an integral part of its examination process, periodically review our allowance for loan losses. The banking regulators may require that we recognize additions to the allowance based on its analysis and review of information available to it at the time of its examination.

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

The following table summarizes the primary segments of the ALL, segregated into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of December 31, 2010 (in thousands):

	Real Estate Loans							
	Residential	**Construction**	**Commercial**	**Commercial Loans**	**Home Equity Loans and Lines of Credit**	**Other Loans**	**Unallocated**	**Total**
ALL balance at December 31, 2010	4,840	15	2,081	148	603	23	28	7,738
Individually evaluated for impairment	239		200	3	58			500
Collectively evaluated for impairment	4,601	15	1,881	145	545	23	28	7,238

The allowance for loan losses is based on estimates, and actual losses will vary from current estimates. Management believes that the granularity of the homogeneous pools and the related historical loss ratios and other qualitative factors, as well as the consistency in the application of assumptions, result in an ALL that is representative of the risk found in the components of the portfolio at any given date.

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The activity in the allowance for loan losses is summarized as follows (in thousands):

	Three Months Ended December 31,	
	2010	2009
Balance, beginning of period	$ 7,448	$ 5,815
Add		
Provision charged to operations	480	500
Loan recoveries	48	25
	7,976	6,340
Less loans charged off	(238)	(136)
Balance, end of period	$ 7,738	$ 6,204

9. Deposits

Deposits consist of the following major classifications (in thousands):

	December 31, 2010	September 30, 2010
Non-interest bearing demand accounts	$ 28,886	$ 30,448
NOW accounts	58,834	61,878
Money market accounts	119,132	119,238
Savings and club accounts	68,376	67,763
Certificates of deposit	306,042	261,083
Total	$ 581,270	$ 540,410

10. Net Periodic Benefit Cost-Defined Benefit Plan

For a detailed disclosure on the Bank s pension and employee benefits plans, please refer to Note 14 of the Company s Consolidated Financial Statements for the year ended September 30, 2010 included in the Company s Form 10-K.

The following table comprises the components of net periodic benefit cost for the periods ended (in thousands):

	Three Months Ended December 31,	
	2010	2009
Service Cost	$ 133	$ 105
Interest Cost	174	143
Expected return on plan assets	(192)	(145)
Amortization of prior service cost	2	2
Amortization of unrecognized loss	101	76

Net periodic benefit cost	$ 218	$ 181

The Bank expects to contribute $500,000 to its pension plan in 2011.

11. Equity Incentive Plan

The Company maintains the ESSA Bancorp, Inc. 2007 Equity Incentive Plan (the Plan). The Plan provides for a total of 2,377,326 shares of common stock for issuance upon the grant or exercise of awards. Of the shares available under the Plan, 1,698,090 may be issued in connection with the exercise of stock options and 679,236 may be issued as restricted stock. The Plan allows for the granting of non-qualified stock options (NSOs), incentive stock options (ISOs), and restricted stock. Options are granted at no less than the fair value of the Company s common stock on the date of the grant.

Certain officers, employees and outside directors were granted in aggregate 1,140,469 NSOs; 317,910 ISOs; and 590,320 shares of restricted stock. In accordance with generally accepted accounting principles for *Share-*

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Based Payments, the Company expenses the fair value of all share-based compensation grants over the requisite service periods.

The Company classifies share-based compensation for employees and outside directors within Compensation and employee benefits in the consolidated statement of income to correspond with the same line item as compensation paid. Additionally, generally accepted accounting principles require the Company to report: (1) the expense associated with the grants as an adjustment to operating cash flows and (2) any benefits of realized tax deductions in excess of previously recognized tax benefits on compensation expense as a financing cash flow.

Stock options vest over a five-year service period and expire ten years after grant date. The Company recognizes compensation expense for the fair values of these awards, which vest on a straight-line basis over the requisite service period of the awards.

Restricted shares vest over a five-year service period. The product of the number of shares granted and the grant date market price of the Company s common stock determines the fair value of restricted shares under the Company s restricted stock plan. The Company recognizes compensation expense for the fair value of restricted shares on a straight-line basis over the requisite service period for the entire award.

For the three months ended December 31, 2010 and 2009, the Company recorded $560,000 of share-based compensation expense, comprised of stock option expense of $190,000 and restricted stock expense of $370,000. Expected future expense relating to the 863,027 non-vested options outstanding as of December 31, 2010, is $1.7 million over the remaining vesting period of 2.42 years. Expected future compensation expense relating to the 351,638 restricted shares at December 31, 2010, is $3.5 million over the remaining vesting period of 2.42 years.

The following is a summary of the Company s stock option activity and related information for its option grants for the three month period ended December 31, 2010.

	Number of Stock Options	Weighted-average Exercise Price	Weighted-average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding, September 30, 2010	1,458,379	$ 12.35	7.67	$
Granted				
Exercised				
Forfeited				
Outstanding, December 31, 2011	1,458,379	$ 12.35	7.42	$ 1,269
Exercisable at December 31, 2011	595,352	$ 12.35	7.42	$ 518

The weighted-average grant date fair value of the Company s non-vested options as of December 31, 2010 and 2009, was $2.38.

The following is a summary of the status of the Company s restricted stock as of December 31, 2010, and changes therein during the three month period then ended:

	Number of Restricted Stock	Weighted-average Grant Date Fair Value
Nonvested at September 30, 2010	352,448	$ 12.35
Granted		
Vested	810	12.35
Forfeited		
Nonvested at December 31, 2010	351,638	$ 12.35

12. Fair Value Measurement

In accordance with U.S. generally accepted accounting principles, the following disclosures show the hierarchal disclosure framework associated within the level of pricing observations utilized in measuring assets and liabilities at fair value. The definition of fair value maintains the exchange price notion in earlier definitions of fair value but focuses on the exit price of the asset or liability. The exit price is the price that would be received to sell

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the asset or paid to transfer the liability adjusted for certain inherent risks and restrictions. Expanded disclosures are also required about the use of fair value to measure assets and liabilities.

The following table presents information about the Company s securities, other real estate owned and impaired loans measured at fair value as of December 31, 2010 and September 30, 2010 and indicates the fair value hierarchy of the valuation techniques utilized by the Bank to determine such fair value:

Fair Value Measurement at December 31, 2010

Fair Value Measurements Utilized for the Company s Financial Assets (in thousands):	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balances as of December 31, 2010
Securities available-for-sale measured on a recurring basis				
Mortgage backed securities	$	$ 196,028	$	$ 196,028
Obligations of states and political subdivisions		16,539		16,539
U.S. government agencies		34,689		34,689
Corporate obligations		2,158		2,158
Equity securities	43			43
Total debt and equity securities	$ 43	$ 249,414	$	$ 249,457
Foreclosed real estate owned measured on a non-recurring basis	$	$ 2,393	$	$ 2,393
Impaired loans measured on a non-recurring basis	$	$ 8,366	$	$ 8,366
Mortgage servicing rights measured on a non-recurring basis	$	$	$ 290	$ 290

Fair Value Measurement at September 30, 2010

Fair Value Measurements Utilized for the Company s Financial Assets (in thousands):	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balances as of December 31, 2010
Securities available-for-sale measured on a recurring basis				
Mortgage backed securities	$	$ 187,288	$	$ 187,288
Obligations of states and political subdivisions		10,904		10,904
U.S. government agencies		52,434		52,434
Corporate obligations		1,677		1,677
Equity securities	38			38
Total debt and equity securities	$ 38	$ 252,303	$	$ 252,341
Foreclosed real estate owned measured on a non-recurring basis	$	$ 2,034	$	$ 2,034
Impaired loans measured on a non-recurring basis	$	$ 7,646	$	$ 7,646
Mortgage servicing rights measured on a non-recurring basis	$	$	$ 318	$ 318

As required by generally accepted accounting principles, each financial asset and liability must be identified as having been valued according to specified level of input, 1, 2 or 3. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Bank has the ability to access at the measurement date. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset, either directly or indirectly. Level 2 inputs include quoted prices for similar assets in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy, within which the fair value measurement in its entirety falls, has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset.

The measurement of fair value should be consistent with one of the following valuation techniques: market approach, income approach, and/or cost approach. The market approach uses prices and other relevant information

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generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on a security s relationship to other benchmark quoted securities. Most of the securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quoted market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond s terms and conditions, among other things. Securities reported at fair value utilizing Level 1 inputs are limited to actively traded equity securities whose market price is readily available from the New York Stock Exchange or the NASDAQ exchange. Other real estate owned (OREO) is measured at fair value, less cost to sell at the date of foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value, less cost to sell. Income and expenses from operations and changes in valuation allowance are included in the net expenses from OREO. Impaired loans are reported at fair value utilizing level two inputs. For these loans, a review of the collateral is conducted and an appropriate allowance for loan losses is allocated to the loan. At December 31, 2010, 56 impaired loans with a carrying value of $8.9 million were reduced by specific valuation allowance totaling $500,000 resulting in a net fair value of $8.4 million based on Level 2 inputs.

Disclosures about Fair Value of Financial Instruments

The fair values presented represent the Company s best estimate of fair value using the methodologies discussed below.

	December 31, 2010		September 31, 2010	
	Carrying Value	**Fair Value**	**Carrying Value**	**Fair Value**
Financial assets:				
Cash and cash equivalents	$ 7,346	$ 7,346	$ 10,890	$ 10,890
Investment and mortgage-backed securities:				
Available for sale	249,457	249,457	252,341	252,341
Held to maturity	11,429	11,653	12,795	13,254
Loans receivable, net	747,822	768,829	730,842	755,871
Accrued interest receivable	4,064	4,064	4,392	4,392
FHLB stock	19,690	19,690	20,727	20,727
Mortgage servicing rights	290	290	318	318
Bank owned life insurance	15,755	15,755	15,618	15,618
Financial liabilities:				
Deposits	$ 581,270	$ 580,254	$ 540,410	$ 548,352
Short-term borrowings	11,856	11,856	14,719	14,719
Other borrowings	310,657	325,016	335,357	353,358
Advances by borrowers for taxes and insurance	3,291	3,291	1,465	1,465
Accrued interest payable	1,781	1,781	1,646	1,646

Financial instruments are defined as cash, evidence of an ownership interest in an entity, or a contract which creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. If a quoted market price is available for a financial instrument, the fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value for financial instruments should be based upon management s judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses, and other factors as determined through various option pricing formulas or simulation modeling.

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As many of these assumptions result from judgments made by management based upon estimates which are inherently uncertain, the resulting values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in the assumptions on which the values are based may have a significant impact on the resulting estimated values.

As certain assets and liabilities, such as deferred tax assets, premises and equipment, and many other operational elements of the Bank, are not considered financial instruments but have value, this fair value of financial instruments would not represent the full market value of the Company.

The Company employed simulation modeling in determining the fair value of financial instruments for which quoted market prices were not available based upon the following assumptions:

Cash and Cash Equivalents, Accrued Interest Receivable, Short-Term Borrowings, Advances by Borrowers for Taxes and Insurance, and Accrued Interest Payable

The fair value approximates the current book value.

Bank-Owned Life Insurance

The fair value is equal to the cash surrender value of the Bank-owned life insurance.

Investment and Mortgage-Backed Securities Available for Sale and Held to Maturity and FHLB Stock

The fair value of investment and mortgage-backed securities available for sale is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities. Since the FHLB stock is not actively traded on a secondary market and held exclusively by member financial institutions, the fair market value approximates the carrying amount.

Loans Receivable, Deposits, Other Borrowings, and Mortgage Servicing Rights

The fair values for loans and mortgage servicing rights are estimated by discounting contractual cash flows and adjusting for prepayment estimates. Discount rates are based upon market rates generally charged for such loans with similar characteristics. Demand, savings, and money market deposit accounts are valued at the amount payable on demand as of year-end. Fair values for time deposits and other borrowings are estimated using a discounted cash flow calculation that applies contractual costs currently being offered in the existing portfolio to current market rates being offered for deposits and borrowings of similar remaining maturities.

Commitments to Extend Credit

These financial instruments are generally not subject to sale, and fair values are not readily available. The carrying value, represented by the net deferred fee arising from the unrecognized commitment, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar credit risk, are not considered material for disclosure.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Forward Looking Statements

This quarterly report contains forward-looking statements, which can be identified by the use of such words as estimate, project, believe, intend, anticipate, plan, seek, expect and similar expressions. These forward-looking statements include:

- statements of our goals, intentions and expectations;

statements regarding our business plans and prospects and growth and operating strategies;

statements regarding the asset quality of our loan and investment portfolios; and

estimates of our risks and future costs and benefits.

By identifying these forward-looking statements for you in this manner, we are alerting you to the possibility that our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements. Important factors that could cause our actual results and financial condition to differ from those indicated in the forward-looking statements include, among

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others, those discussed under Risk Factors in Part I, Item 1A of the Company s Annual Report on Form 10-K and Part II, Item 1A of this Report on Form 10-Q, as well as the following factors:

- significantly increased competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;
- general economic conditions, either nationally or in our market areas, that are worse than expected;
- adverse changes in the securities markets;
- legislative or regulatory changes that adversely affect our business;
- our ability to enter new markets successfully and take advantage of growth opportunities, and the possible short-term dilutive effect of potential acquisitions or *de novo* branches, if any;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies and the Financial Accounting Standards Board; and
- changes in our organization, compensation and benefit plans.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

Comparison of Financial Condition at December 31, 2010 and September 30, 2010

Total Assets. Total assets increased by $9.0 million, or 0.8%, to $1,081.0 million at December 31, 2010 from $1,072.0 million at September 30, 2010. This increase was primarily due to an increase in net loans receivable.

Investment Securities Available for Sale. Investment securities available for sale decreased $2.9 million, or 1.1%, to $249.5 million at December 31, 2010 from $252.3 million at September 30, 2010. The decrease was due primarily to a decrease of $17.7 million in the Company s portfolio of United States government sponsored agency securities and was offset in part by a $8.7 million increase in the Company s portfolio of mortgage-backed securities issued by United States government sponsored agencies and a $5.6 million increase in obligations of state and political subdivisions.

Investment securities held to maturity. Investment securities held to maturity decreased $1.4 million, or 10.7%, to $11.4 million at December 31, 2010 from $12.8 million at September 30, 2010. The decrease was due to normal repayments received on the mortgage-backed portfolio.

Net Loans. Net loans increased $17.0 million, or 2.3%, to $747.8 million at December 31, 2010 from $730.8 million at September 30, 2010. The increase in net loans receivable was primarily attributed to an increase in commercial real estate loans. During this period, commercial real estate loans outstanding increased by $16.3 million to $94.4 million. Residential real estate loans and construction loans also increased from

September 30, 2010 to December 31, 2010 by $2.7 million and $453,000, respectively. These increases were partially offset by decreases in commercial loans outstanding of $1.1 million to $15.5 million, home equity loans and lines of credit outstanding of $928,000 to $42.6 million and other loans outstanding of $255,000 to $2.2 million.

Deposits. Deposits increased $40.9 million, or 7.6%, to $581.3 million at December 31, 2010 from $540.4 million at September 30, 2010. At December 31, 2010 compared to September 30, 2010, certificate of deposit accounts increased $45.0 million to $306.0 million, and savings and club accounts increased $613,000 to $68.4 million. These increases were offset in part during the same period by decreases in non-interest bearing demand accounts of $1.6 million to $28.9 million, NOW accounts of $3.0 million to $58.8 million and savings and money market accounts of $106,000 to $119.1 million. Included in the certificates of deposit at December 31, 2010 was an increase of $31.2 million in brokered certificates of deposit to $101.9 million. The increase in brokered certificates was the result of the Company s decision to replace maturing FHLBank Pittsburgh borrowings with lower priced brokered certificates of deposit.

Borrowed Funds. Borrowed funds decreased by $27.6 million, or 7.9%, to $322.5 million at December 31, 2010, from $350.1 million at September 30, 2010. The decrease in borrowed funds was primarily due to maturities of FHLBank Pittsburgh borrowings.

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Stockholders Equity. Stockholders equity decreased by $5.5 million, or 3.2%, to $166.2 million at December 31, 2010 from $171.6 million at September 30, 2010. This decrease was primarily the result of a stock repurchase program the company began in June 2008 and an increase in the Company s accumulated other comprehensive loss. The accumulated other comprehensive loss increased by $2.7 million at December 31, 2010 compared to September 30, 2010 primarily due to a decrease in the unrealized gain, net of taxes, on the Company s investment securities available for sale. The unrealized gain decreased due to changes in interest rates. In June, 2009, the Company announced that is had completed its first stock repurchase program having purchased 2,547,135 shares at a weighted average cost of $13.14. It was also announced that the Company s Board of Directors authorized a second stock repurchase program to purchase up to an additional 10% of its outstanding shares. On October 6, 2010, the Company announced that it had completed its second stock repurchase program having purchased 1,499,100 shares at a weighted average cost of $12.36 including 23,700 shares repurchased during the quarter ended December 31, 2010. It was also announced that the Company s Board of Directors authorized a third repurchase program to purchase up to an additional 5% of its outstanding shares. As of December 31, 2010, the Company had purchased an additional 277,100 shares at a weighted average cost of $12.83 per share under the third stock repurchase program. In total, the Company purchased 300,800 shares at a weighted average cost of $12.77 per share for the three months ended December 31, 2010.

Average Balance Sheets for the Three Months Ended December 31, 2010 and 2009

The following tables set forth average balance sheets, average yields and costs, and certain other information for the periods indicated. All average balances are daily average balances, the yields set forth below include the effect of deferred fees and discounts and premiums that are amortized or accreted to interest income.

	For the Three Months Ended December 31					
	2010			2009		
	Average Balance	Interest Income/ Expense	Yield/ Cost	Average Balance	Interest Income/ Expense	Yield/ Cost
	(dollars in thousands)					
Interest-earning assets:						
Loans (1)	$ 739,735	$ 9,844	5.28%	$ 737,346	$ 10,341	5.56%
Investment securities						
Taxable (2)	50,509	208	1.63%	30,304	185	2.44%
Exempt from federal income tax (2) (3)	6,840	78	6.85%	7,423	83	6.64%
Total investment securities	57,349	286	2.26%	37,727	268	3.26%
Mortgage-backed securities	202,637	1,714	3.36%	189,705	2,052	4.29%
Federal Home Loan Bank stock	20,002		0.00%	20,727		0.00%
Other	1,609		0.00%	3,965	1	0.10%
Total interest-earning assets	1,021,332	11,844	4.62%	989,470	12,662	5.09%
Allowance for loan losses	(7,628)			(5,920)		
Noninterest-earning assets	54,552			47,517		
Total assets	$ 1,068,256			$ 1,031,067		
Interest-bearing liabilities:						
NOW accounts	$ 58,185	6	0.04%	$ 53,874	10	0.07%
Money market accounts	117,685	166	0.56%	109,511	318	1.15%
Savings and club accounts	66,504	42	0.25%	65,240	58	0.35%
Certificates of deposit	284,905	1,482	2.06%	145,160	1,020	2.79%
Borrowed funds	330,377	3,018	3.62%	435,419	3,973	3.62%
Total interest-bearing liabilities	$ 857,656	$ 4,714	2.18%	$ 809,204	$ 5,379	2.64%
Non-interest bearing NOW accounts	29,230			26,667		
Noninterest-bearing liabilities	10,162			9,417		

Total liabilities	897,048			845,288		
Equity	171,208			185,779		
Total liabilities and equity	$ 1,068,256			$ 1,031,067		
Net interest income		$ 7,130			$ 7,283	
Interest rate spread			2.44%			2.45%
Net interest-earning assets	$ 163,676			$ 180,266		
Net interest margin (4)			2.77%			2.92%
Average interest-earning assets to average interest-bearing liabilities		119.08%			122.28%	

(footnotes continue on the following page)

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(1) Non-accruing loans are included in the outstanding loan balances.
(2) Held to maturity securities are reported at amortized cost. Available for sale securities are reported at fair value.
(3) Yields on tax exempt securities have been calculated on a fully tax equivalent basis assuming a tax rate of 34%.
(4) Represents the difference between interest earned and interest paid, divided by average total interest earning assets.

Comparison of Operating Results for the Three Months Ended December 31, 2010 and December 31, 2009

Net Income. Net income increased $218,000 million, or 27.5%, to $1.0 million for the three months ended December 31, 2010 compared to net income of $794,000 for the comparable period in 2009. The net income of $794,000 for the three months ending December 31, 2010 included a pre-tax write-down of $1.2 million in the value of the Company s foreclosed real estate portfolio. The charge related to a single property in the Bank s foreclosed real estate portfolio and was made to reflect a more current appraisal.

Net Interest Income. Net interest income decreased $153,000 or 2.1%, to $7.1 million for the three months ended December 31, 2010 from $7.3 million for the comparable period in 2009. The decrease was primarily attributable to a decrease in the Company s average net earning assets of $16.6 million, and a decrease in the Company s interest rate spread to 2.44% for the three months ended December 31, 2010, from 2.45% for the comparable period in 2009.

Interest Income. Interest income decreased $818,000 or 6.5%, to $11.8 million for the three months ended December 31, 2010 from $12.7 million for the comparable 2009 period. The decrease resulted primarily from a 47 basis point decrease in average yield on interest earning assets partially offset by a $31.9 million increase in average interest-earning assets. The average yield on interest earning assets was 4.62% for the three months ended December 31, 2010, as compared to 5.09% for the comparable 2009 period as the Company s interest earning assets continued to re-price downward throughout the period. Loans increased on average $2.4 million between the two periods along with increases in the average balance of mortgage backed securities of $12.9 million. In addition, average taxable investment securities increased $20.2 million. These increases were offset in part by decreases in the average balances of tax exempt investment securities of $583,000 and average other interest earning assets of $2.4 million. The primary reason for the increase in mortgage backed and taxable investment securities was the partial reinvestment of borrowing proceeds, deposit proceeds and maturing investment securities into these assets. Average FHLBank Pittsburgh stock declined $725,000 as a result of a repurchase by the FHLB of stock in the quarter ended December 31, 2010. As a member of the FHLB system, the Bank maintains an investment in the capital stock of the FHLB in an amount not less than 45 basis points of the outstanding FHLB member asset value plus 4.6% of its outstanding FHLB borrowings, as calculated throughout the year. On December 23, 2008, the FHLBank Pittsburgh notified its members, including the Company, that it was suspending the payment of dividends on its capital stock and the repurchase of excess capital stock until further notice. The decrease in other interest earning assets was primarily due to a decrease in the average balance of cash held at FHLBank Pittsburgh.

Interest Expense. Interest expense decreased $665,000 or 12.4%, to $4.7 million for the three months ended December 31, 2010 from $5.4 million for the comparable 2009 period. The decrease resulted from a 46 basis point decrease in the overall cost of interest bearing liabilities to 2.18% for the three months ended December 31, 2010 from 2.64% for the comparable 2009 period, partially offset by a $48.5 million increase in average interest-bearing liabilities. Average interest bearing deposits increased $153.5 million and average borrowed funds decreased $105.0 million. Average interest bearing deposits increased primarily as a result of a $139.7 million increase in average certificates of deposit.

Provision for Loan Losses. In evaluating the level of the allowance for loan losses, management considers historical loss experience, the types of loans and the amount of loans in the loan portfolio, adverse situations that may affect a borrower s ability to repay, the estimated value of any underlying collateral, peer group information and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are subject to interpretation and revision as more information becomes available or as future events occur. After an evaluation of these factors, management made a provision for loan losses of $480,000 for the three months ended December 31, 2010 as compared to $500,000 for the three months ended December 31, 2009. The allowance for loan losses was $7.7 million, or 1.02% of loans outstanding, at December 31, 2010, compared to $6.2 million, or 0.84% of loans outstanding at December 31, 2009.

Non-interest Income. Non-interest income decreased $121,000 or 8.3%, to $1.3 million from $1.5 million for the comparable period in 2009. The primary reason for the decrease was the decline in gains on the sale of loans of $152,000 during the 2010 period. The Company sold $5.7 million of long-term fixed-rate residential loans during the three months ended December 31, 2009, as compared to $97,000 for the corresponding 2010 period.

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Non-interest Expense. Non-interest expense decreased $593,000, or 8.2%, to $6.6 million for the three months ended December 31, 2010 from $7.2 million for the comparable period in 2009. The primary reason for the decrease was a decline in loss on foreclosed real estate of $1.1 million. This decrease was offset, in part, by increases in occupancy and equipment expense of $218,000, compensation and employee benefits of $144,000, and other expense of $174,000. Other expense increased due primarily to increases in other professional fees, appraisal and lien search fees, and REO operations, which increased $33,000, $90,000, and $43,000 respectively. Compensation and employee benefits increased primarily as a result of staff increases required for the opening of four branches in 2010. Occupancy and equipment increased primarily because of a one-time accrual adjustment in real estate taxes of approximately $115,000 which was taken in 2009.

Income Taxes. Income tax expense increased $121,000 to $335,000 for the three months ended December 31, 2010 from $214,000 for the comparable 2009 period. The increase was primarily a result of the increase in income before taxes of $339,000 million for the three months ended December 31, 2010. The effective tax rate was 24.9% for the three months ended December 31, 2010, compared to 21.2% for the 2009 period.

Non-Performing Assets

The following table provides information with respect to the Bank s non-performing assets at the dates indicated. (Dollars in thousands)

	December 31, 2010	September 30, 2010
Non-performing assets:		
Non-accruing loans	$ 11,929	$ 10,516
Troubled debt restructures	358	361
Total non-performing loans	12,287	10,877
Foreclosed real estate	2,393	2,034
Total non-performing assets	$ 14,680	$ 12,911
Ratio of non-performing loans to total loans	1.63%	1.47%
Ratio of non-performing loans to total assets	1.14%	1.01%
Ratio of non-performing assets to total assets	1.36%	1.20%
Ratio of allowance for loan losses to total loans	1.02%	1.01%

Loans are reviewed on a regular basis and are placed on non-accrual status when they become more than 90 days delinquent. When loans are placed on non-accrual status, unpaid accrued interest is fully reserved, and further income is recognized only to the extent received. Nonperforming assets increased $1.8 million to $14.7 million at December 31, 2010 from $12.9 million at September 30, 2010. Nonperforming loans increased $1.4 million to $12.3 million at December 31, 2010 from $10.9 million at September 30, 2010. The $11.9 million of non-accruing loans included 50 residential loans with an aggregate outstanding balance of $9.4 million that were past due 90 or more days at December 31, 2010, 15 commercial loans with aggregate outstanding balances of $2.2 million and 11 consumer loans with aggregate balances of $376,000. Foreclosed real estate increased $359,000 to $2.4 million at December 31, 2010 from $2.0 million at September 30, 2010. The $359,000 increase included the addition of 6 residential properties valued at $416,000 to the foreclosed real estate portfolio which was partially offset by write-downs of $72,000.

Liquidity and Capital Resources

We maintain liquid assets at levels we consider adequate to meet both our short-term and long-term liquidity needs. We adjust our liquidity levels to fund deposit outflows, repay our borrowings and to fund loan commitments. We also adjust liquidity as appropriate to meet asset and liability management objectives.

Our primary sources of liquidity are deposits, prepayment and repayment of loans and mortgage-backed securities, maturities of investment securities and other short-term investments, and earnings and funds provided from operations, as well as access to FHLBank advances and other borrowing sources. While scheduled principal repayments on loans and mortgage-backed securities are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competition. We set the interest rates on our deposits to maintain a desired level of total deposits.

A portion of our liquidity consists of cash and cash equivalents and borrowings, which are a product of our operating, investing and financing activities. At December 31, 2010, $7.3 million of our assets were invested in cash and cash equivalents. Our primary sources of cash are principal repayments on loans, proceeds from the maturities of investment securities, principal repayments of mortgage-backed securities and increases in deposit accounts. Short-term investment securities (maturing in one year or less) totaled $9,000 at December 31, 2010. As of December 31, 2010, we had $257.5 million in borrowings outstanding from FHLBank Pittsburgh and $65.0 million in borrowings through repurchase agreements with other financial institutions. We have access to additional FHLBank advances of up to approximately $253.8 million.

At December 31, 2010, we had $52.4 million in loan commitments outstanding, which included, in part, $3.7 million in undisbursed construction loans, $22.4 million in unused home equity lines of credit, $8.3 million in commercial lines of credit and $14.2 million to originate primarily multi-family and nonresidential mortgage loans. Certificates of deposit due within one year of December 31, 2010 totaled $113.0 million, or 36.9% of certificates of deposit. If these maturing deposits do not remain with us, we will be required to seek other sources of funds, including other certificates of deposit and borrowings. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before December 31, 2011. We believe, however, based on past experience, that a significant portion of our certificates of deposit will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

As reported in the Consolidated Statements of Cash Flows, our cash flows are classified for financial reporting purposes as operating, investing or financing cash flows. Net cash provided by operating activities was $3.3 million and $1.3 million for the three months ended December 31, 2010 and 2009, respectively. These amounts differ from our net income because of a variety of cash receipts and disbursements that did not affect net income for the respective periods. Net cash provided (used) in investing activities was $(17.4) million and $6.4 million for the three months ended December 31, 2010 and 2009, respectively, principally reflecting our loan and investment security activities. Deposit and borrowing cash flows have comprised most of our financing activities which resulted in net cash provided (used) of $10.5 million and $(8.2) million for the three months ended December 31, 2010 and 2009, respectively.

Critical Accounting Policies

We consider accounting policies that require management to exercise significant judgment or discretion or make significant assumptions that have, or could have, a material impact on the carrying value of certain assets or on income, to be critical accounting policies. We consider the following to be our critical accounting policies:

Allowance for Loan Losses. The allowance for loan losses is the estimated amount considered necessary to cover credit losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses which is charged against income. In determining the allowance for loan losses, management makes significant estimates and has identified this policy as one of our most critical. The methodology for determining the allowance for loan losses is considered a critical accounting policy by management due to the high degree of judgment involved, the subjectivity of the assumptions utilized and the potential for changes in the economic environment that could result in changes to the amount of the recorded allowance for loan losses.

As a substantial amount of our loan portfolio is collateralized by real estate, appraisals of the underlying value of property securing loans and discounted cash flow valuations of properties are critical in determining the amount of the allowance required for specific loans. Assumptions for appraisals and discounted cash flow valuations are instrumental in determining the value of properties. Overly optimistic assumptions or negative changes to assumptions could significantly impact the valuation of a property securing a loan and the related allowance determined. The assumptions supporting such appraisals and discounted cash flow valuations are carefully reviewed by management to determine that the resulting values reasonably reflect amounts realizable on the related loans.

Management performs a quarterly evaluation of the adequacy of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, delinquency statistics, geographic and industry concentrations, the adequacy of the underlying collateral, the financial strength of the borrower, results of internal and external loan reviews and other relevant factors. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revision based on changes in economic and real estate market conditions.

The analysis of the allowance for loan losses has two components: specific and general allocations. Specific allocations are made for loans that are determined to be impaired. Impairment is measured by determining the present value of expected future cash flows or, for collateral-dependent loans, the fair value of the collateral

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adjusted for market conditions and selling expenses. The general allocation is determined by segregating the remaining loans by type of loan, risk weighting (if applicable) and payment history. We also analyze historical loss experience, delinquency trends, general economic conditions and geographic and industry concentrations. This analysis establishes factors that are applied to the loan groups to determine the amount of the general allocations. Actual loan losses may be significantly more than the allowance for loan losses we have established which could have a material negative effect on our financial results.

Other-than-Temporary Investment Security Impairment. Securities are evaluated periodically to determine whether a decline in their value is other-than-temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other-than-temporary. The term other-than-temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other-than-temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

Deferred Income Taxes. We use the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance is established. We consider the determination of this valuation allowance to be a critical accounting policy because of the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income. These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amount of taxes recoverable through loss carryback declines, or if we project lower levels of future taxable income. Such a valuation allowance would be established through a charge to income tax expense which would adversely affect our operating results. At December 31, 2010 the Company had a $2.8 million valuation allowance established against its deferred tax asset. The tax deduction generated by the contribution to the Foundation as part of the Company s stock offering exceeded the allowable federal income tax deduction limitations resulting in the establishment of this valuation allowance for the contribution carry forward.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements (as such term is defined in applicable Securities and Exchange Commission rules) that are reasonably likely to have a current or future material effect on our financial condition, results of operations, liquidity, capital expenditures or capital resources.

Contractual Obligations

During the first three months of fiscal 2011, the Company s contractual obligations did not change materially from those discussed in the Company s Financial Statements for the year ended September 30, 2010.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The majority of our assets and liabilities are monetary in nature. Consequently, our most significant form of market risk is interest rate risk. Our assets, consisting primarily of mortgage loans, have longer maturities than our liabilities, consisting primarily of deposits and borrowings. As a result, a principal part of our business strategy is to manage interest rate risk and reduce the exposure of our net interest income to changes in market interest rates. Accordingly, our Board of Directors has approved guidelines for managing the interest rate risk inherent in our assets and liabilities, given our business strategy, operating environment, capital, liquidity and performance objectives. Senior management monitors the level of interest rate risk on a regular basis and the asset/liability committee meets quarterly to review our asset/liability policies and interest rate risk position.

We have sought to manage our interest rate risk in order to minimize the exposure of our earnings and capital to changes in interest rates. The net proceeds from the offering increased our capital and provided management with greater flexibility to manage our interest rate risk. In particular, management used the majority of the capital we received to increase our interest-earning assets. There have been no material changes in our interest rate risk since September 30, 2010.

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Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our Principal Executive Officer and Principal Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

There were no significant changes made in the Company s internal controls over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) or in other factors that could significantly affect the Company s internal controls over financial reporting during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

Part II Other Information

Item 1. Legal Proceedings

The Company and its subsidiaries are subject to various legal actions arising in the normal course of business. In the opinion of management, the resolution of these legal actions is not expected to have a material adverse effect on the Company s financial condition or results of operations.

Item 1A. Risk Factors

There have been no material changes in the Risk Factors disclosed in the Company s Annual Report for the fiscal year ended September 30, 2010 on Form 10-K filed on December 14, 2010.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table presents a summary of the Company s share repurchases during the quarter ended December 31, 2010.

Company Purchases of Common Stock

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares that may yet be purchased under the plans or programs
October 1 October 31, 2010	135,222	$ 12.59	135,000	561,600
November 1 November 28, 2010	73,100	12.76	73,100	488,500
December 1 December 31, 2010	92,700	12.92	92,700	395,800
Total	301,022	$ 12.73	300,800	

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. [Removed and Reserved]

Item 5. Other Information

Not applicable.

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Item 6. Exhibits

The following exhibits are either filed as part of this report or are incorporated herein by reference:

3.1	Certificate of Incorporation of ESSA Bancorp, Inc.*
3.2	Bylaws of ESSA Bancorp, Inc.*
4	Form of Common Stock Certificate of ESSA Bancorp, Inc.*
10.2	Amended and Restated Employment Agreement for Gary S. Olson**
10.3	Amended and Restated Employment Agreement for Robert S. Howes**
10.4	Amended and Restated Employment Agreement for Allan A. Muto**
10.5	Amended and Restated Employment Agreement for Diane K. Reimer**
10.6	Amended and Restated Employment Agreement for V. Gail Warner**
10.7	Supplemental Executive Retirement Plan**
10.8	Endorsement Split Dollar Life Insurance Agreement for Gary S. Olson**
10.9	Endorsement Split Dollar Life Insurance Agreement for Robert S. Howes**
21	Subsidiaries of Registrant*
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*

Incorporated by reference to the Registration Statement on Form S-1 of ESSA Bancorp, Inc. (file no. 333-139157), originally filed with the Securities and Exchange Commission on December 7, 2006.

** Incorporated by reference to ESSA Bancorp, Inc. s current report on Form 8-K filed with the Securities and Exchange Commission on October 6, 2008.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	ESSA BANCORP, INC.
Date: February 9, 2011	/s/ Gary S. Olson Gary S. Olson President and Chief Executive Officer
Date: February 9, 2011	/s/ Allan A. Muto Allan A. Muto Executive Vice President and Chief Financial Officer