BOX INC
Form 10-Q
September 11, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 31, 2015

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO

Commission File Number 001-36805

Box, Inc.

(Exact name of registrant as specified in its charter)

Delaware	20-2714444
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

4440 El Camino Real

Los Altos, California 94022

(Address of principal executive offices and Zip Code)

(877) 729-4269

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (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 for such 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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

As of August 31, 2015, the number of shares of the registrant's Class A common stock outstanding was 37,504,205 and the number of shares of the registrant's Class B common stock outstanding was 83,951,688.

TABLE OF CONTENTS

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which statements involve substantial risks and uncertainties. Forward-looking statements generally relate to future events or our future financial or operating performance. In some cases, you can identify forward-looking statements because they contain words such as “may,” “will,” “should,” “expects,” “plans,” “anticipates,” “could,” “intends,” “target,” “projects,” “believes,” “estimates,” “predicts,” “potential” or “continue” or the negative of these words or other similar terms or expressio that concern our expectations, strategy, plans or intentions. Forward-looking statements contained in this Quarterly Report on Form 10-Q include, but are not limited to, statements about:

- our ability to maintain an adequate rate of revenue and billings growth;
- our business plan and our ability to effectively manage our growth;
- costs associated with defending intellectual property infringement and other claims;
- our ability to attract and retain end-customers;
- our ability to further penetrate our existing customer base;
- our ability to displace existing products in established markets;
- our ability to expand our leadership position in enterprise content management and collaboration solutions;
- our ability to timely and effectively scale and adapt our existing technology;
- our ability to innovate new products and bring them to market in a timely manner;
- our ability to expand internationally;
- the effects of increased competition in our market and our ability to compete effectively;
- the effects of seasonal trends on our operating results;
- our expectations concerning relationships with third parties;
- the attraction and retention of qualified employees and key personnel;
- our ability to maintain, protect and enhance our brand and intellectual property; and
- future acquisitions of or investments in complementary companies, products, services or technologies.

These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in the section titled “Risk Factors” and elsewhere in this Quarterly Report on Form 10-Q. Moreover, we operate in a very competitive and rapidly changing environment, and new risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this Quarterly Report on Form 10-Q may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements.

You should not rely upon forward-looking statements as predictions of future events. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee that the future results, levels of activity, performance or events and circumstances reflected in the forward-looking statements will be achieved or occur. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. We undertake no obligation to update publicly any forward-looking statements for any reason after the date of this Quarterly Report on Form 10-Q to conform these statements to actual results or to changes in our expectations, except as required by law.

You should read this Quarterly Report on Form 10-Q and the documents that we reference in this Quarterly Report on Form 10-Q and have filed with the SEC as exhibits to this Quarterly Report on Form 10-Q with the understanding that our actual future results, levels of activity, performance, and events and circumstances may be materially different from what we expect.

3

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

BOX, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	July 31, 2015 (unaudited)	January 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 140,119	$ 330,436
Marketable securities	102,120	—
Accounts receivable, net of allowance of $3,791 and $3,858	54,047	54,174
Prepaid expenses, restricted cash and other current assets	37,465	12,132
Deferred commissions	9,598	9,487
Total current assets	343,349	406,229
Property and equipment, net	79,629	58,446
Intangible assets, net	6,836	6,343
Goodwill	14,301	11,242
Restricted cash	27,617	3,367
Other long-term assets	8,269	7,039
Total assets	$ 480,001	$ 492,666
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 22,980	$ 17,486
Accrued compensation and benefits	23,278	20,486
Accrued expenses and other current liabilities	21,918	16,862
Capital lease obligations, current	1,915	625
Deferred revenue	118,289	107,893
Deferred rent	1,087	2,701
Total current liabilities	189,467	166,053
Debt, non-current	40,000	40,000
Capital lease obligations, non-current	3,273	1,238
Deferred revenue, non-current	12,060	12,164
Deferred rent, non-current	32,841	3,890
Other long-term liabilities	1,718	1,192
Total liabilities	279,359	224,537

Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, par value $0.0001 per share; 100,000 shares authorized, no shares issued and outstanding as of July 31, 2015 (unaudited) and January 31, 2015, respectively	—	—
Class A common stock, par value $0.0001 per share; 1,000,000 shares authorized, 36,308 shares issued and outstanding as of July 31, 2015 (unaudited); 1,000,000 shares authorized, 14,455 shares issued and outstanding as of January 31, 2015	4	1
Class B common stock, par value $0.0001 per share; 200,000 shares authorized, 85,037 shares issued and outstanding as of July 31, 2015 (unaudited); 200,000 shares authorized, 105,200 shares issued and outstanding as of January 31, 2015 (including common stock subject to repurchase, see Note 10)	8	11
Additional paid-in capital	828,749	798,743
Treasury stock	(1,177)	(1,177)
Accumulated other comprehensive loss	(91)	(56)
Accumulated deficit	(626,851)	(529,393)
Total stockholders' equity	200,642	268,129
Total liabilities and stockholders' equity	$ 480,001	$ 492,666

See notes to condensed consolidated financial statements.

BOX, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(unaudited)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2015	2014	2015	2014
Revenue	$73,450	$51,423	$139,071	$96,753
Cost of revenue	20,636	10,833	37,789	20,061
Gross profit	52,814	40,590	101,282	76,692
Operating expenses:				
Research and development	26,453	16,345	49,587	31,243
Sales and marketing	58,460	49,657	114,955	97,097
General and administrative	17,675	12,875	33,147	24,421
Total operating expenses	102,588	78,877	197,689	152,761
Loss from operations	(49,774)	(38,287)	(96,407)	(76,069)
Remeasurement of redeemable convertible preferred stock warrant liability	—	461	—	194
Interest expenses, net	(229)	(382)	(743)	(787)
Other expense, net	(31)	(71)	(108)	(64)
Loss before provision (benefit) for income taxes	(50,034)	(38,279)	(97,258)	(76,726)
Provision (benefit) for income taxes	141	(717)	200	(653)
Net loss	(50,175)	(37,562)	(97,458)	(76,073)
Accretion of redeemable convertible preferred stock	—	(1,791)	—	(1,834)
Net loss attributable to common stockholders	$(50,175)	$(39,353)	$(97,458)	$(77,907)
Net loss per common share attributable to common stockholders, basic and diluted	$(0.42)	$(2.71)	$(0.81)	$(5.51)
Weighted-average shares used to compute net loss per share attributable to common stockholders, basic and diluted	120,399	14,533	119,897	14,140

See notes to condensed consolidated financial statements.

BOX, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(In thousands)

(unaudited)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2015	2014	2015	2014
Net loss	$(50,175)	$(37,562)	$(97,458)	$(76,073)
Other comprehensive loss*:				
Changes in foreign currency translation adjustment	(21)	(7)	(28)	(5)
Net change in unrealized gains on available-for-sale investments	(9)	—	(7)	—
Other comprehensive loss	(30)	(7)	(35)	(5)
Comprehensive loss	$(50,205)	$(37,569)	$(97,493)	$(76,078)

*Tax effect was not material
See notes to condensed consolidated financial statements.

BOX, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Three Months Ended July 31, 2015	Three Months Ended July 31, 2014	Six Months Ended July 31, 2015	Six Months Ended July 31, 2014
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss	$(50,175)	$(37,562)	$(97,458)	$(76,073)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	9,865	6,433	19,031	12,329
Stock-based compensation expense	14,728	8,079	27,443	13,831
Amortization of deferred commissions	3,922	2,974	7,528	5,832
Remeasurement of redeemable convertible preferred stock warrant liability	—	(461)	—	(194)
Release of deferred tax valuation allowance	—	(825)	—	(825)
Other	102	156	100	313
Changes in operating assets and liabilities, net of effects of acquisitions:				
Accounts receivable	(15,496)	(4,028)	127	6,558
Deferred commissions	(5,354)	(3,160)	(8,167)	(5,949)
Prepaid expenses, restricted cash and other assets	1,343	(2,245)	(27,112)	(4,528)
Accounts payable	8,602	(596)	8,868	718
Accrued expenses and other liabilities	2,560	(246)	1,563	(6,534)
Deferred rent	2,094	1,557	3,942	2,252
Deferred revenue	6,148	3,644	10,292	2,522
Net cash used in operating activities	(21,661)	(26,280)	(53,843)	(49,748)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchases of marketable securities	(6,202)	—	(112,521)	—
Sales of marketable securities	709	—	3,849	—
Maturities of marketable securities	6,653	—	6,653	—
Purchases of property and equipment	(17,943)	(16,293)	(27,844)	(22,254)
Acquisitions and purchases of intangible assets, net of cash acquired	(18)	(102)	(218)	(102)
Net cash used in investing activities	(16,801)	(16,395)	(130,081)	(22,356)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Payment of initial public offering costs	(839)	(1,013)	(2,172)	(2,748)
Proceeds from borrowings, net of borrowing costs	—	12,000	—	12,000
Proceeds from issuance of redeemable convertible preferred stock, net of issuance costs	—	149,619	—	149,619
	1,618	528	2,414	2,105

Proceeds from exercise of stock options, net of repurchases of early exercised stock options				
Employee payroll taxes paid related to net share settlement of restricted stock units	(1,972)	—	(6,187)	—
Payments of capital lease obligations	(192)	—	(420)	—
Net cash (used in) provided by financing activities	(1,385)	161,134	(6,365)	160,976
Effect of exchange rate changes on cash and cash equivalents	(21)	(7)	(28)	(5)
Net increase (decrease) in cash and cash equivalents	(39,868)	118,452	(190,317)	88,867
Cash and cash equivalents, beginning of period	179,987	79,266	330,436	108,851
Cash and cash equivalents, end of period	$140,119	$197,718	$140,119	$197,718
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid for interest	$293	$142	$652	$348
Cash paid for income taxes, net of tax refunds	242	(17)	700	107
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:				
Accretion of redeemable convertible preferred shares	$—	$1,791	$—	$1,834
Change in accrued equipment purchases	8,446	(9,926)	5,648	(393)
Purchases of property and equipment under capital lease	2,335	—	4,065	—
Issuance of common stock in connection with acquisitions and purchases of intangible assets	5,444	4,305	6,108	4,305
Change in unpaid deferred offering costs	(839)	(848)	(2,172)	(1,259)

See notes to condensed consolidated financial statements.

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Description of Business and Basis of Presentation

Description of Business

We were incorporated in the state of Washington in April 2005, and were reincorporated in the state of Delaware in March 2008. We changed our name from Box.Net, Inc. to Box, Inc. in November 2011. We provide a cloud-based mobile optimized enterprise content management and collaboration platform that enables organizations of all sizes to easily and securely manage their content from anywhere, and collaborate internally and externally.

Basis of Presentation

The accompanying condensed consolidated balance sheet as of July 31, 2015 and the condensed consolidated statements of operations, the condensed consolidated statements of comprehensive loss and the condensed consolidated statements of cash flows for the three and six months ended July 31, 2015 and 2014, respectively, are unaudited. The condensed consolidated balance sheet data as of January 31, 2015 was derived from the audited consolidated financial statements that are included in our Form 10-K for the fiscal year ended January 31, 2015, which was filed with the Securities and Exchange Commission (the SEC) on March 30, 2015. The accompanying statements should be read in conjunction with the audited consolidated financial statements and related notes contained in our fiscal 2015 Form 10-K.

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information. Accordingly, they do not include all of the financial information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of our management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in the Form 10-K, and include all adjustments necessary for the fair presentation of our balance sheet as of July 31, 2015, and our results of operations, including our comprehensive loss, and our cash flows for the three and six months ended July 31, 2015 and 2014. All adjustments are of a normal recurring nature. The results for the three and six months ended July 31, 2015 are not necessarily indicative of the results to be expected for any subsequent quarter or for the fiscal year ending January 31, 2016.

Prior Period Reclassifications

Certain reclassifications of prior period amounts have been made to conform to the current period presentation.

Note 2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make, on an ongoing basis, estimates and assumptions that affect the amounts reported and disclosed in the financial statements and the accompanying notes. Actual results could differ from these estimates. Such estimates include, but are not limited to, the determination of the allowance for accounts receivable, fair value of acquired intangible assets and goodwill, useful lives of acquired intangible assets and property and equipment, best estimate of selling price included in multiple-deliverable revenue arrangements, fair values of stock-based awards, legal contingencies, and the provision for income taxes, including related reserves, among others. Management bases its estimates on historical experience and on various other assumptions which management believes to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Revenue Recognition

We derive our revenue from three sources: (1) subscription revenue, which is comprised of subscription fees from customers utilizing our cloud-based enterprise content management and collaboration services, which include routine customer support, and Box Enterprise Key Management (EKM); (2) revenue from customers purchasing our premier support package; and (3) revenue from professional services such as implementing best practice use cases, project management and implementation consulting services.

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

We recognize revenue when all of the following conditions are met:

- there is persuasive evidence of an arrangement;
- the service has been provided to the customer;
- the collection of fees is reasonably assured; and
- the amount of fees to be paid by the customer is fixed or determinable.

We typically invoice our customers at the beginning of the term, in multiyear, annual, quarterly or monthly installments. Our subscription and support contracts are typically non-cancellable and do not contain refund-type provisions.

In instances where we collect fees in advance of service delivery, revenue under the contract is deferred until we successfully deliver such services.

Subscription revenue is recognized ratably over the period of the subscription beginning once all requirements for revenue recognition have been met, including provisioning the service so that it is available to our customers. Premier support is sold together with the subscription services, and the term of the premier support is generally the same as the related subscription services arrangement. Accordingly, we recognize premier support revenue in the same manner as the associated subscription hosting service. Professional services revenue is recognized as the services are rendered for time and material contracts, and using the proportional performance method over the period the services are performed for fixed price contracts.

We assess collectability based on a number of factors, such as past collection history and creditworthiness of the customer. If management determines collectability is not reasonably assured, we defer revenue recognition until collectability becomes reasonably assured.

Our arrangements can include multiple elements which may consist of some or all of subscription services, premier support and professional services. When multiple-element arrangements exist, we evaluate whether these individual deliverables should be accounted for as separate units of accounting or one single unit of accounting.

In order to treat deliverables in a multiple-element arrangement as separate units of accounting, the delivered item or items must have standalone value upon delivery. A delivered item has standalone value to the customer when either (1) any vendor sells that item separately or (2) the customer could resell that item on a standalone basis. Our subscription services have standalone value as such services are often sold separately. Our premier support services do not have standalone value because we and other vendors do not sell premier support services separately. Our professional services have standalone value because there are other vendors which sell the same professional services separately. For new services, we assess standalone value consistently with the foregoing policy. Accordingly, we consider the separate units of accounting in our multiple deliverable arrangements to be the professional services, subscription services or a combined deliverable comprised of subscription services and premier support services. When multiple deliverables included in an arrangement are separable into different units of accounting, the arrangement consideration is allocated to the identified separate units of accounting based on their relative selling price. Multiple-element arrangement accounting guidance provides a hierarchy to use when determining the relative selling price for each unit of accounting. Vendor-specific objective evidence (VSOE) of selling price, based on the price at which the item is regularly sold by the vendor on a standalone basis, should be used if it exists. If VSOE of selling price is not available, third-party evidence (TPE) of selling price is used to establish the selling price if it exists. We have not established VSOE for our subscription services, premier support or professional services due to lack of pricing consistency, the introduction of new services and other factors. We have also concluded that third-party evidence of selling price is not a practical alternative due to differences in our service offerings compared to other parties and the availability of relevant third-party pricing information. Accordingly, we use our best estimate of selling price (BESP) to determine the relative selling price for our subscription, premier support and professional services offerings. For arrangements with multiple deliverables which can be separated into different units of accounting, we allocate the arrangement fee to the separate units of accounting based on our BESP. The amount of arrangement fee allocated is limited by contingent revenue, if any.

We determined BESP by considering our overall pricing objectives and market conditions. Significant pricing practices taken into consideration for our subscription services, which may also include premier support, and professional services, include discounting practices, the size and volume of our transactions, the customer demographic, the geographic area where services are sold, price lists, our go-to-market strategy, historical standalone sales and contract prices. The determination of BESP is made through consultation with and approval by our management, taking into consideration the go-to-market strategy. As our go-to-market strategies evolve, we may modify our pricing practices in the future, which could result in changes in relative selling prices.

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Certain Risks and Concentrations

Our financial instruments that are exposed to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, restricted cash and accounts receivable. Although we deposit our cash with multiple financial institutions, our deposits, at times, may exceed federally insured limits.

We sell to a broad range of customers. Our revenue is derived substantially from the U.S. across a multitude of industries. Accounts receivable are derived from the delivery of our services to customers primarily located in the U.S. We accept and settle our accounts receivable using credit cards, electronic payments and checks. A majority of our lower dollar value invoices are settled by credit card on or near the date of the invoice. We do not require collateral from customers to secure accounts receivable. We maintain an allowance for accounts receivable based upon the expected collectability, which takes into consideration specific customer creditworthiness and current economic trends. We believe collections of our accounts receivable are reasonably assured based on the size, industry diversification, financial condition and past transaction history of our customers. As of July 31, 2015 and January 31, 2015, no single customer accounted for more than 10% of total accounts receivable. No single customer represented over 10% of revenue during the three and six months ended July 31, 2015 and 2014.

We serve our customers and users from datacenter facilities operated by third parties. In order to reduce the risk of down time of our enterprise cloud content management services, we have established datacenters in various locations in the United States. We have internal procedures to restore services in the event of disaster at one of our current datacenter facilities. Even with these procedures for disaster recovery in place, our cloud services could be significantly interrupted during the implementation of the procedures to restore services.

Geographic Locations

Revenue attributed to the United States was 80% and 78% for the three months ended July 31, 2015 and 2014, respectively, and 80% and 79% for the six months ended July 31, 2015 and 2014, respectively. No other country outside of the United States comprised 10% or greater of our revenue for all periods presented.

Substantially all of our net assets are located in the United States. As of July 31, 2015 and January 31, 2015, property and equipment located in the United States was 99% and 98%, respectively.

Foreign Currency Translation and Transactions

The functional currency of our principal foreign subsidiaries is generally the U.S. dollar. Adjustments resulting from translating foreign functional currency financial statements into U.S. dollars for those entities that do not have U.S. dollars as their functional currency are recorded as part of a separate component of the consolidated statements of comprehensive loss. Foreign currency transaction gains and losses are included in the consolidated statements of operations for the period. All assets and liabilities denominated in a foreign currency are translated into U.S. dollars at the exchange rate on the balance sheet date. Revenue and expenses are translated at the average exchange rate during the period. Equity transactions are translated using historical exchange rates. Translation adjustments at the balance sheet dates were not material. Transaction gains and losses recognized were not material for all periods presented.

Restricted Cash

Restricted cash is comprised of certificates of deposit and money market funds related to our credit card processing and leases.

Marketable Securities

Our marketable securities consisted of corporate paper, U.S. government agency obligations, corporate debt securities, asset-backed securities and U.S. government obligations. We classify our marketable securities as available-for-sale at the time of purchase and reevaluate such classification as of each balance sheet date. We may sell these securities at any time for use in current operations or for other purposes, such as consideration for acquisitions, even if they have not yet reached maturity. As a result, we classify our marketable securities, including securities with maturities beyond twelve months as current assets in the accompanying consolidated balance sheets. All marketable securities are recorded at their estimated fair value. Unrealized gains and losses for available-for-sale securities are recorded in other comprehensive income (loss). We evaluate our marketable securities to assess whether those with unrealized loss positions are other than temporarily impaired. We consider impairments to be other than temporary if they are related

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

to deterioration in credit risk or if it is likely we will sell the securities before the recovery of their cost basis. Realized gains and losses and declines in value deemed to be other than temporary are determined based on the specific identification method and are reported in other income (expense), net in the consolidated statements of operations.

Recent Accounting Pronouncement

In May 2014, the FASB issued ASU 2014-09 regarding ASC Topic 606, Revenue from Contracts with Customers. The standard provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard will be effective for us beginning February 1, 2018, at which time we may adopt the new standard under either the full retrospective method or the modified retrospective method. Early adoption is permitted. We are currently evaluating the impact of the adoption of this standard on our consolidated financial statements and have not determined whether the effect will be material.

Note 3. Fair Value Measurements

We define fair value as the exchange price that would be received from selling an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. We measure our financial assets and liabilities at fair value at each reporting period using a fair value hierarchy which requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's classification within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Three levels of inputs may be used to measure fair value:

- Level 1—Observable inputs are unadjusted quoted prices in active markets for identical assets or liabilities.
- Level 2—Observable inputs are quoted prices for similar assets and liabilities in active markets or inputs other than quoted prices which are observable for the assets or liabilities, either directly or indirectly through market corroboration, for substantially the full term of the financial instruments.
- Level 3—Unobservable inputs which are supported by little or no market activity and which are significant to the fair value of the assets or liabilities. These inputs are based on our own assumptions used to measure assets and liabilities at fair value and require significant management judgment or estimation.

We measure our marketable securities and restricted cash at fair value on a recurring basis. We classify our marketable securities and restricted cash within Level 1 or Level 2 because they are valued using either quoted market prices for identical assets or inputs other than quoted prices which are directly or indirectly observable in the market, including readily-available pricing sources for the identical underlying security which may not be actively traded.

The following tables set forth the fair value of our financial assets measured at fair value on a recurring basis as of July 31, 2015 and January 31, 2015, using the above input categories (in thousands):

	July 31, 2015			
	Level 1	Level 2	Level 3	Fair Value
Assets				
Marketable securities:				
Corporate paper	—	37,746	—	37,746
U.S. government agency obligations	—	20,301	—	20,301
Corporate debt securities	—	21,081	—	21,081
Asset-backed securities	—	11,732	—	11,732
U.S. government obligations	—	11,260	—	11,260
Prepaid expenses, restricted cash and other current assets:				
Certificates of deposit	—	750	—	750
Restricted cash:				
Certificates of deposit	—	26,414	—	26,414
Money market funds	1,203	—	—	1,203
Total assets measured at fair value	$1,203	$129,284	$ —	$130,487

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

	January 31, 2015			
	Level 1	Level 2	Level 3	Fair Value
Assets				
Restricted cash:				
Certificates of deposit	$—	$3,367	$ —	$3,367
Total assets measured at fair value	$—	$3,367	$ —	$3,367

Note 4. Marketable Securities

We held no marketable securities as of January 31, 2015. The following is a summary of our marketable securities as of July 31, 2015 (in thousands).

	July 31, 2015			
	Amortized Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
Corporate paper	$37,739	$ 7	$ —	$37,746
U.S. government agency obligations	20,301	2	(2)	20,301
Corporate debt securities	21,095	1	(15)	21,081
Asset-backed securities	11,735	—	(3)	11,732
U.S. government obligations	11,260	—	—	11,260
	$102,130	$ 10	$ (20)	$102,120

None of our marketable securities had been in an unrealized loss position for greater than 12 months as of July 31, 2015. Based on our evaluation of available evidence we concluded that the gross unrealized losses on our marketable securities as of July 31, 2015, are temporary in nature.

The amortized cost and estimated fair value of our marketable securities as of July 31, 2015 are shown below by contractual maturity (in thousands).

	July 31, 2015	
	Amortized	Estimated

	Cost	Fair Value
Less than one year	$91,908	$91,900
Due in one to five years	10,222	10,220
	$102,130	$102,120

Net realized gains and losses from sales of our available-for-sale securities for the three and six months ended July 31, 2015 were not significant.

Note 5. Balance Sheet Components

Prepaid Expenses, Restricted Cash and Other Current Assets

Prepaid expenses, restricted cash and other current assets consisted of the following (in thousands):

	July 31, 2015	January 31, 2015
Tenant incentives receivable under our new headquarters lease in Redwood City (see Note 8)	$23,395	$—
Restricted cash and other	14,070	12,132
Total prepaid expenses, restricted cash and other current assets	$37,465	$12,132

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Property and Equipment, Net

Property and equipment, net consisted of the following (in thousands):

	July 31, 2015	January 31, 2015
Servers	$94,405	$81,068
Leasehold improvements	13,947	13,400
Computer hardware and software	10,011	8,724
Furniture and fixtures	5,448	5,046
Construction in progress	26,799	4,815
Total property and equipment	150,610	113,053
Less: accumulated depreciation	(70,981)	(54,607)
Total property and equipment, net	$79,629	$58,446

As of July 31, 2015, the gross carrying amount of property and equipment includes $4.8 million of servers and $1.2 million of construction in progress acquired under capital leases, and the accumulated depreciation of property and equipment acquired under these capital leases was $750,000. As of January 31, 2015, the gross carrying amount of property and equipment includes $1.9 million of servers and $69,000 of construction in progress acquired under capital leases, and the accumulated depreciation of property and equipment acquired under these capital leases was $140,000.

Depreciation expense related to property and equipment was $8.4 million and $5.6 million for the three months ended July 31, 2015 and 2014, respectively, and $16.4 million and $10.8 million for the six months ended July 31, 2015 and 2014, respectively. Included in these amounts was depreciation expense for servers acquired under capital leases in the amount of $396,000 and $610,000 for the three and six months ended July 31, 2015, respectively. We held no property and equipment under capital lease during the three and six months ended July 31, 2014. Construction in progress primarily consists of leasehold improvements related to our new Redwood City headquarters and other facilities, as well as servers, networking equipment and storage infrastructure being provisioned in our third party datacenter hosting facilities. In addition, the amounts of interest capitalized to property and equipment were $92,000 and $138,000 for the three months ended July 31, 2015 and 2014, respectively, and $98,000 and $227,000 for the six months ended July 31, 2015 and 2014, respectively.

Note 6. Acquisitions

Verold, Inc.

On May 4, 2015, for a total purchase price of $5.4 million (in our common stock), we acquired certain assets of, and hired certain employees from, Verold Inc., a privately-held technology company which has built a cloud-based 3D model viewer and editor. The acquisition has been accounted for as a business combination. Of the $5.4 million, $2.8 million was attributed to developed technology and $2.6 million to goodwill. Developed technology is being amortized on a straight-line basis over an estimated useful life of two years. Goodwill is primarily attributable to the enhancement of the Box user experience and the value of acquired personnel. Goodwill is deductible for U.S. income tax purposes. Transaction costs related to this acquisition were immaterial.

Results of operations for this acquisition have been included in our consolidated statements of operations since the acquisition date and were not material. Pro forma results of operations for this acquisition have not been presented because they were also not material to the consolidated results of operations.

Other Acquisitions

During the six months ended July 31, 2015, we purchased and licensed certain assets of two other companies for an aggregate purchase price of $764,000. We accounted for these transactions as business combinations. In allocating the purchase consideration based on estimated fair values, we recorded $349,000 of developed technology and $415,000 of goodwill. Goodwill for these acquisitions is deductible for U.S. income tax purposes. Developed technology is being amortized on a straight-line basis over an estimated useful life of two years. These acquisitions are expected to enhance our Box service by leveraging the acquired companies’ technologies, along with gaining access to their key talent. Aggregate transaction costs related to these acquisitions were immaterial.

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Results of operations for these acquisitions have been included in our consolidated statements of operations since the acquisition dates and were not material. Pro forma results of operations for these acquisitions have not been presented because they were also not material to the consolidated results of operations.

Note 7. Goodwill and Intangible Assets

Goodwill activity is reflected in the following table (in thousands):

Balance as of January 31, 2015	$11,242
Goodwill acquired—Verold	2,644
Goodwill acquired—Other	415
Balance as of July 31, 2015	$14,301

Intangible assets consisted of the following (in thousands):

	Weighted Average Useful Life (1)	Gross Value	Accumulated Amortization	Net Carrying Value
July 31, 2015				
Developed technology	2.5 years	$14,274	$ (7,848)	$ 6,426
Trade name and other	6.9 years	1,201	(791)	410
Intangibles, net		$15,475	$ (8,639)	$ 6,836
January 31, 2015				
Developed technology	2.7 years	$11,124	$ (5,268)	$ 5,856
Trade name and other	6.9 years	1,201	(714)	487
Intangibles, net		$12,325	$ (5,982)	$ 6,343

(1) From the date of acquisition

Intangible amortization expense was $1.5 million and $801,000 for the three months ended July 31, 2015 and 2014, respectively, and $2.7 million and $1.5 million for the six months ended July 31, 2015 and 2014, respectively. Amortization of acquired technology is included in cost of revenue and amortization for trade names is included in general and administrative expenses in the consolidated statements of operations. As of July 31, 2015, expected amortization expense for intangible assets was as follows (in thousands):

Years ending January 31:	
Remainder of 2016	$2,941
2017	3,352
2018	519
2019	23
2020	1
	$6,836

Note 8. Commitments and Contingencies

Letters of Credit

As of July 31, 2015 and January 31, 2015, we had letters of credit in the amount of $27.0 million in connection with our facility leases. These letters of credit mature at various dates through December 1, 2018. As of July 31, 2015 and January 31, 2015, certain letters of credit are collateralized by certificates of deposit held by us in the amount of $27.0 million and $2.0 million, respectively. Refer to Note 9 for additional details.

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Leases

We have entered into various non-cancellable operating lease agreements for certain of our offices and datacenters with lease periods expiring primarily between fiscal years 2016 and 2029. Certain of these arrangements have free or escalating rent payment provisions and optional renewal clauses. We are also committed to pay a portion of the actual operating expenses under certain of these lease agreements. These operating expenses are not included in the table below.

We also entered into various capital lease arrangements to obtain servers for our operations. These agreements are typically for three years. The leases are secured by the underlying leased servers.

As of July 31, 2015, future minimum lease payments under non-cancellable capital and operating leases are as follows (in thousands):

Years ending January 31:	Capital Leases	Operating Leases, net of Sublease Income
Remainder of 2016	$ 1,030	$ 3,683
2017	2,060	14,069
2018	1,984	19,985
2019	356	21,361
2020	—	23,795
Thereafter		193,571
Total minimum lease payments	$ 5,430	$ 276,464
Less: amount representing interest	(242)	
Present value of minimum lease payments	$ 5,188	

In March and April 2015, we signed subleases for three floors of our new headquarters. The 18 and 36-month subleases expire in fiscal 2018 and 2019, respectively, and non-cancellable sublease proceeds of $12.4 million are included in the table above. In addition, because our subtenants will occupy the subleased portions of our new headquarters prior to the related lease commencement date, we will incur contingent rent payments of $5.4 million, which are also included in the table above.

We recognize rent expense under our operating leases on a straight-line basis. Rent expense totaled $5.6 million and $1.6 million, net of sublease income of $48,000 and $415,000 for the three months ended July 31, 2015 and 2014, respectively, and rent expense totaled $9.3 million and $3.0 million, net of sublease income of $294,000 and $852,000 for the six months ended July 31, 2015 and 2014, respectively.

We establish assets and liabilities for the present value of estimated future costs to return certain of our leased facilities to their original condition. Such assets are depreciated over the lease period into operating expense, and the recorded liabilities are accreted to the future value of the estimated restoration costs. As of July 31, 2015 and January 31, 2015, we had such asset retirement obligations in the amount of $142,000 and $135,000, respectively, which are included in other noncurrent liabilities in the consolidated balance sheets.

Purchase Obligations

As of July 31, 2015, future payments under non-cancellable contractual purchases, which relate primarily to datacenter operations and marketing activities, are as follows (in thousands):

Years ending January 31:	
Remainder of 2016	$9,828
2017	13,615
2018	4,287
	$27,730

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Legal Matters

On June 5, 2013, Open Text S.A. (Open Text) filed a lawsuit against us in the U.S. District Court, Eastern District of Virginia, alleging that our core cloud software and Box Edit application infringe 12 patents of Open Text. Open Text sought preliminary and permanent injunctions against infringement, treble damages, and attorneys' fees. This case was subsequently transferred to the U.S. District Court for the Northern District of California.

On September 13, 2013, Open Text filed a motion for preliminary injunction seeking to enjoin us from providing our Box Edit feature to companies with more than 100 users. On April 9, 2014, the California court denied Open Text's motion for preliminary injunction, finding that (1) Open Text failed to meet its burden to show irreparable harm, (2) Open Text failed to show a reasonable likelihood of success on the merits of its case, and (3) we have raised a substantial question as to the validity of the patents asserted during the preliminary injunction proceedings.

On September 19, 2014, in a related action, Open Text S.A. v. Alfresco Software Ltd., et al., Case No. 13-cv-04843-JD, the Court granted the Alfresco Defendants' motion to dismiss with prejudice the asserted claims of the Dialog Patents, finding the asserted claims of the Dialog Patents patent ineligible under 35 U.S.C. § 101. On January 20, 2015, the Court entered an Order granting our motion for judgment on the pleadings as to the asserted patent claims of the Groupware Patents. The Court found that the asserted patent claims of the Groupware Patents are invalid because they claim non-patentable subject matter. As a result of the Court's January 20, 2015 order and other pretrial orders, the lawsuit was narrowed to four total claims across the three remaining File Synchronization Patents accusing the Company's Box Edit feature and Box Android application.

Trial commenced on February 2, 2015. On February 13, 2015, the jury returned a verdict, finding the asserted claims of the File Synchronization patents infringed and were not invalid. The jury awarded damages in favor of Open Text in a lump sum and fully paid-up royalty in the amount of $4.9 million. The Court found no willful infringement of the asserted claims and foreclosed Open Text's request for a permanent injunction since the jury returned a lump-sum award. On February 19, 2015, Open Text filed a notice of appeal to the United States Court of Appeals for the Federal Circuit from the Court's Order granting our motion for judgment of invalidity of the Groupware Patents. On March 9, 2015, Open Text filed a first amended notice of appeal from additional orders by the Court. On August 19, 2015, following a July 1, 2015 hearing in which portions of the jury's verdict were challenged, the Court entered judgment in favor of Open Text with respect to infringement of the asserted claims of the File Synchronization patents in the amount of approximately $4.9 million plus pre-judgment interest, and with respect to validity of the asserted claims of the File Synchronization patents. The Court also entered judgment in our favor with respect to invalidity of the asserted claims of the Groupware Patents, and no willful infringement with respect to the asserted claims of the File Synchronization patents.

While we intend to continue to defend the lawsuit vigorously and continue to believe we have valid defense to Open Text's claims, we considered the issuance of the verdict a recognized subsequent event that provided additional evidence about conditions that existed as of January 31, 2015. Accordingly, we accrued a liability in the amount of $4.9 million related to the legal verdict as of January 31, 2015, and recorded an expense in the amount of $3.9 million for the year ended January 31, 2015, in relation to the portion of the legal verdict amount attributable to prior periods. The portion of the legal verdict amount attributable to future periods is recorded as an asset as of January 31, 2015. This asset is being amortized over an estimated useful life of 14 months, and the amortization expense was $223,000 and $409,000 for the three and six months ended July 31, 2015, respectively. In addition, as a result of the July 1, 2015 hearing, we deemed the claim for interest on the legal verdict amount to be probable and estimable for the first time. As such, we accrued an additional liability of $569,000 as of July 31, 2015, in relation to the interest on the legal verdict amount.

In addition to the litigation discussed above, from time to time, we are a party to litigation and subject to claims that arise in the ordinary course of business. We investigate these claims as they arise, and accrue estimates for resolution of litigation and other contingencies when losses are probable and estimable. Although the results of litigation and claims cannot be predicted with certainty, we believe there was not at least a reasonable possibility that we had incurred a material loss with respect to such loss contingencies as of July 31, 2015 for which a reserve was not already established.

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Indemnification

We include service level commitments to our customers warranting certain levels of uptime reliability and performance and permitting those customers to receive credits in the event that we fail to meet those levels. In addition, our customer contracts often include (i) specific obligations that we maintain the availability of the customer's data through our service and that we secure customer content against unauthorized access or loss, and (ii) indemnity provisions whereby we indemnify our customers for third-party claims asserted against them that result from our failure to maintain the availability of their content or securing the same from unauthorized access or loss. To date, we have not incurred any material costs as a result of such commitments.

Our arrangements generally include certain provisions for indemnifying customers against liabilities if our products or services infringe a third party's intellectual property rights. It is not possible to determine the maximum potential amount under these indemnification obligations due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. To date, we have not incurred any material costs as a result of such obligations and have not accrued any liabilities related to such obligations in the consolidated financial statements. In addition, we indemnify our officers, directors and certain key employees while they are serving in good faith in their respective capacities. To date, there have been no claims under any indemnification provisions.

Note 9. Debt

Line of Credit

In August 2013, we entered into a two-year $100.0 million secured revolving credit facility. The credit facility is denominated in U.S. dollars and, depending on certain conditions, each borrowing is subject to a floating interest rate equal to the London Interbank Offer Rate (LIBOR) plus 3.0% or the Alternate Base Rate (ABR) plus 2.0%. In addition, there is a commitment fee of 0.5% on outstanding unused commitment amount. At closing, we drew $34.0 million at 3.4% (six month LIBOR plus 3.0%) which we used to repay previous loans, as well as for other general corporate purposes. In July 2014, we drew an additional $12.0 million under the credit facility at 3.3% (six month LIBOR plus 3.0%). In September 2014, we paid down $6.0 million and amended the credit facility to reduce our borrowing capacity from $100.0 million to $75.0 million and extend the facility through August 2016. Concurrently and in conjunction with the execution of our new headquarters lease in September 2014, letters of credit in the aggregate amount of $25.0 million were issued under the credit facility. These letters of credit were subject to interest at 3.25% per annum.

In March 2015, we amended the credit facility to reduce our borrowing capacity to $60.0 million as of April 2015, and to increase certain limitations on the amount of capital asset and real estate related obligations we may incur. In connection with this amendment, the letters of credit under the credit facility were cancelled, and a new letter of credit in the amount of $25.0 million was issued by a party not affiliated with the credit facility, which was secured by a certificate of deposit in the same amount. As of July 31, 2015, the outstanding borrowings under the credit facility were $40.0 million, and our remaining borrowing capacity under the credit facility was $20.0 million.

Borrowings under the credit facility are collateralized by substantially all of our assets. The credit facility also contains various covenants, including covenants related to the delivery of financial and other information, the maintenance of quarterly financial covenants, material adverse effects, as well as limitations on dispositions, mergers or consolidations and other corporate activities. As of July 31, 2015, we were in compliance with all financial covenants.

In connection with the credit facility, we incurred interest expense of $436,000 and $548,000 during the three months ended July 31, 2015 and 2014, respectively, and $1.1 million and $1.1 million during the six months ended July 31, 2015 and 2014, respectively. During the same periods, we capitalized $92,000 and $138,000 of interest costs during the three months ended July 31, 2015 and 2014, respectively, and $98,000 and $227,000 during the six months ended July 31, 2015 and 2014, respectively. Interest expense also includes amortization of issuance costs, unused commitment fees and fees on letters of credit which are recognized over the related term of the borrowing.

BOX, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Note 10. Stock-Based Compensation

2015 Equity Incentive Plan

In January 2015, our board of directors adopted the 2015 Equity Incentive Plan (2015 Plan), which became effective prior to the completion of our initial public offering (IPO). A total of 12,200,000 shares of Class A common stock was initially reserved for issuance pursuant to future awards under the 2015 Plan. Additionally, any shares subject to outstanding awards under our 2006 Equity Incentive Plan (2006 Plan) or 2011 Equity Incentive Plan (2011 Plan) that are cancelled or repurchased subsequent to the 2015 Plan's effective date will be returned to the pool of shares reserved for issuance under the 2015 Plan. Awards granted under the 2015 Plan may be (i) incentive stock options, (ii) nonstatutory stock options, (iii) restricted stock units, (iv) restricted stock awards or (v) stock appreciation rights, as determined by our board of directors at the time of grant. Options and restricted stock units generally vest 25% one year from the vesting commencement date and (a) in the case of options, 1/48th per month thereafter, and (b) in the case of restricted stock units, 1/16th per quarter thereafter. As of July 31, 2015, 15,006,222 shares were reserved for future issuance under the 2015 Plan.

2015 Employee Stock Purchase Plan

In January 2015, our board of directors adopted the 2015 Employee Stock Purchase Plan, which became effective prior to the completion of our IPO. A total of 2,500,000 shares of Class A common stock was initially reserved for issuance under the 2015 ESPP. The 2015 ESPP allows eligible employees to purchase shares of our Class A common stock at a discount through payroll deductions of up to 15% of their eligible compensation, subject to any plan limitations. Except for the initial offering period, the 2015 ESPP provides for 24-month offering periods beginning March 16 and September 16 of each year, and each offering period will consist of four six-month purchase periods. The initial offering period began January 23, 2015, and will end on March 15, 2017.

On each purchase date, eligible employees will purchase our stock at a price per share equal to 85% of the lesser of (1) the fair market value of our stock on the offering date or (2) the fair market value of our stock on the purchase date. As of July 31, 2015, 3,696,550 shares were reserved for future issuance under the 2015 ESPP.

Early Exercises of Stock Options

Prior to our IPO, certain employees and directors exercised stock options prior to vesting with the approval of our board of directors. The unvested shares are subject to a repurchase right held by us at the original purchase price. Early exercises of options are not deemed to be substantive exercises for accounting purposes, and accordingly, amounts received for early exercises are initially recorded in other liabilities and are reclassified to common stock and additional paid-in capital as the underlying shares vest. As of July 31, 2015 and January 31, 2015, we had $58,000 and $286,000, respectively, in liabilities and 45,624 and 113,541 unvested shares subject to repurchase related to early exercises of stock options.

Stock Options

The following table summarizes the stock option activity under the equity incentive plans and related information:

	Shares Subject to Options Outstanding			
	Shares Subject to Outstanding Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
Balance as of January 31, 2015	17,465,571	$ 5.67	7.80	$ 229,713
Options granted	1,264,650	17.40		
Option exercised	(788,879)	3.25		
Options forfeited/cancelled	(958,637)	7.70		

36

Regulatory Requirements. This reduced rate structure has had a negative impact on our fee income. However, debit card usage by our customers grew which has had a positive impact on our debit card fee income. Thus, the new law's limits on debit transaction interchange fees has not had a material adverse impact on our financial condition or results of operations since the law's enactment. This increase in income from debit card transactions was offset, in part, by a decrease in fee income from service charges on deposit accounts.

IV. NONINTEREST EXPENSE

Noninterest expense is a means of measuring the delivery cost of services, products and business activities of a company. The key components of noninterest expense are presented in the following table.

ANALYSIS OF NONINTEREST EXPENSE
(Dollars In Thousands)

	Years Ended December 31,			Change From Prior Year			
				2012 to 2013		2011 to 2012	
	2013	2012	2011	Amount	%	Amount	%
Salaries and Employee Benefits	$31,182	$31,703	$30,205	$(521)	(1.6)%	$1,498	5.0 %
Occupancy Expense of Premises, Net	4,582	3,970	3,891	612	15.4	79	2.0
Furniture and Equipment Expense	3,703	3,497	3,478	206	5.9	19	0.5
FDIC Regular Assessment	1,080	1,026	1,292	54	5.3	(266)	(20.6)
Amortization of Intangible Assets	452	517	510	(65)	(12.6)	7	1.4
Prepayment Penalty on FHLB Advances	—	—	1,638	—	—	(1,638)	—
Other Operating Expense	12,204	11,123	10,534	1,081	9.7	589	5.6
Total Noninterest Expense	$53,203	$51,836	$51,548	$1,367	2.6	$288	0.6
Efficiency Ratio	59.73 %	58.62 %	58.23 %	1.11 %	1.9	0.39 %	0.7

2013 compared to 2012: Noninterest expense for 2013 amounted to $53.2 million, an increase of $1.4 million, or 2.6%, from 2012. For 2013, our efficiency ratio was 59.73%. This ratio, which is a commonly used non-GAAP financial measure in the banking industry, is a comparative measure of a financial institution's operating efficiency. The efficiency ratio (a ratio where lower is better), as we define it, is the ratio of operating noninterest expense (excluding intangible asset amortization and the FHLB prepayment penalty) to net interest income (on a tax-equivalent basis) plus operating noninterest income (excluding net securities gains or losses). See the discussion of the efficiency ratio on page 4 of this Report under the heading "Use of Non-GAAP Financial Measures." The efficiency ratio as defined by the Federal Reserve Board and reported for banks in its "Peer Holding Company Performance Reports" excludes net securities gains or losses from the denominator (as does our calculation), but unlike our ratio includes intangible asset amortization in the numerator, and thus tends to result in higher ratios than our definition. Our efficiency ratios in recent periods compared favorably to the ratios of our peer group, even as adjusted to add intangible asset amortization back into the numerator of our ratio (i.e., into our operating noninterest expense). For 2013, our peer group ratio was 70.5%, and our ratio (not adjusted) was 60.2%.

Salaries and employee benefits expense, which typically represents from 55-60% of total noninterest expense, decreased by $521 thousand, or 1.6%, from 2012 to 2013. Salary expense was virtually the same in 2013 as in 2012. Most of the decrease in employee benefits was attributable to a decrease in pension expense between the two periods.

Both building and equipment expenses increased from 2012 to 2013. In both cases, the increase is primarily attributable to an increase in depreciation expense reflecting the significant investments we have made in improving our facilities and information technology infrastructure over the past two years.

Other operating expense increased $1.1 million, or 9.7% from 2012. This was primarily the result of an increase of $1.3 million for off-premise computer services offset, in part, by a $319 thousand decrease in telecommunications expense. These two trends reflect the increasing complexity of electronic services banks now provide apart from our core banking applications and the benefit from competitive pricing as more vendors enter into the marketplace.

2012 compared to 2011: Noninterest expense for 2012 amounted to $51.8 million, an increase of $288 thousand, or .6%, from 2011. For 2012, our efficiency ratio was 58.62%. For 2012, our peer group ratio (adjusted to include intangible asset amortization in the numerator) was 70.2%; our ratio (not adjusted) was 59.2%.

Salaries and employee benefits expense, which typically represents from 55-60% of total noninterest expense, increased by $1.5 million, or 5.0%, from 2011 to 2012. Salary expense increased $885 thousand, or 4.3%, from 2011 primarily due to annual salary increases. Pension costs increased $563 thousand, or 40.5% from 2011 to 2012, due primarily to a decrease in the discount rate used to calculate the net periodic benefit cost.

The principal reason noninterest expense remained virtually unchanged from 2011 to 2012, despite the 5.0% increase between the two years in the largest component of this measure (salaries and employee benefits), is because our FDIC assessments dropped by $266 thousand (or 20.5%) between the two years, and the prepayment penalty we recognized in 2011 in connection with our prepayment of FHLB advances during that year ($1.6 million), was not replicated in 2012.

The significant decrease in our FDIC assessment from 2011 to 2012 directly resulted from a change in the way the FDIC calculates deposit insurance premiums payable by banks,which first took effect in the second quarter of 2011. Under the new method, the FDIC now calculates premiums based on adjusted assets rather than deposits. This resulted in substantial decreases in our FDIC insurance expense both in 2011 and in 2012. The positive impact of the change in our year-to-year noninterest expense did not, however, extend beyond 2012. In all periods, we continued to pay the lowest possible rate.

Other operating expense increased $589 thousand, or 5.6% from 2011. This was primarily the result of an increase of $295 thousand, or 17.8% for off-premise computer services and $245 thousand, or 28.9% increase in loan fees. Occupancy and equipment expenses did not significantly change from 2011 to 2012.

V. INCOME TAXES

The following table sets forth our provision for income taxes and effective tax rates for the periods presented.

INCOME TAXES AND EFFECTIVE RATES
(Dollars In Thousands)

	Years Ended December 31,			Change From Prior Year			
				2012 to 2013		2011 to 2012	
	2013	2012	2011	Amount	%	Amount	%
Provision for Income Taxes	$9,079	$9,661	$9,714	$(582)	(6.0)%	$(53)	(0.5)%
Effective Tax Rate	29.4%	30.3%	30.7%	(0.9)%	(3.0)	(0.4)%	(1.3)

The provisions for federal and state income taxes amounted to $9.1 million for 2013 and $9.7 million for both 2012 and 2011. The effective income tax rates for 2013, 2012 and 2011 were 29.4%, 30.3% and 30.7%, respectively. The changes reflect an increasing proportion of tax-equivalent income to pre-tax income.

C. FINANCIAL CONDITION

I. INVESTMENT PORTFOLIO

Investment securities are classified as held-to-maturity, trading, or available-for-sale, depending on the purposes for which such securities are acquired and thereafter held. Securities held-to-maturity are debt securities that we have both the positive intent and ability to hold to maturity; such securities are stated at amortized cost. Debt and equity securities that are bought and held principally for the purpose of sale in the near term are classified as trading securities and are reported at fair value with unrealized gains and losses included in earnings. Debt and equity securities not classified as either held-to-maturity or trading securities are classified as available-for-sale and are reported at fair value with unrealized gains and losses excluded from earnings and reported net of taxes in accumulated other comprehensive income or loss. During 2013, 2012 and 2011, we held no trading securities. Set forth below is certain information about our securities available-for-sale portfolio and securities held-to-maturity portfolio.

Securities Available-for-Sale:

The following table sets forth the carrying value of our securities available-for-sale portfolio at year-end 2013, 2012 and 2011.

SECURITIES AVAILABLE-FOR-SALE
(In Thousands)

	December 31,		
	2013	2012	2011
U.S. Agency Obligations	$136,475	$122,457	$116,393

State and Municipal Obligations	127,389	84,838	44,999
Mortgage-Backed Securities - Residential	175,778	261,804	392,712
Corporate and Other Debt Securities	16,798	8,451	1,015
Mutual Funds and Equity Securities	1,166	1,148	1,419
Total	$457,606	$478,698	$556,538

In all periods, Mortgage-Backed Securities-Residential consisted solely of mortgage pass-through securities issued or guaranteed by U.S. federal agencies. Pass-through securities provide to the investor monthly portions of principal and interest pursuant to the contractual obligations of the underlying mortgages. Collateralized Mortgage Obligations ("CMOs"), which are interests in bundles of mortgage-backed securities, the repayments on which have been separated into two or more components (tranches), where each tranche has a separate estimated life and yield. Our practice has been to purchase only pass-through securities and CMOs that are issued or guaranteed by U.S. federal agencies, and the tranches of CMOs that we purchase generally are those having shorter maturities. Included in our Corporate and Other Debt Securities for each of the periods are corporate bonds that were highly rated at the time of purchase, although in some cases the securities had been downgraded before the reporting date, but still at investment grade.

38

The following table sets forth the maturities of the debt securities in our available-for-sale portfolio as of December 31, 2013. CMOs and other mortgage-backed securities are included in the table based on their expected average lives.

MATURITIES OF DEBT SECURITIES AVAILABLE-FOR-SALE
(In Thousands)

	Within One Year	After 1 But Within 5 Years	After 5 But Within 10 Years	After 10 Years	Total
U.S. Agency Obligations	—	136,475	—	—	136,475
State and Municipal Obligations	48,623	76,405	1,681	680	127,389
Mortgage-Backed Securities - Residential	11,181	150,330	14,146	121	175,778
Corporate and Other Debt Securities	—	15,998	—	800	16,798
Total	59,804	379,208	15,827	1,601	456,440

The following table sets forth the tax-equivalent yields of the debt securities in our available-for-sale portfolio at December 31, 2013.

YIELDS ON SECURITIES AVAILABLE-FOR-SALE
(Fully Tax-Equivalent Basis)

	Within One Year		After 1 But Within 5 Years		After 5 But Within 10 Years		After 10 Years		Total	
U.S. Agency Obligations	—	%	0.51	%	—	%	—	%	0.51	%
State and Municipal Obligations	1.22		1.39		7.10		8.14		1.44	
Mortgage-Backed Securities - Residential	4.09		2.53		3.75		4.24		2.73	
Corporate and Other Debt Securities	—		0.89		—		3.00		1.01	
Total	1.75		1.49		4.12		5.02		1.63	

The yields on obligations of states and municipalities exempt from federal taxation were computed on a fully tax-equivalent basis using a marginal tax rate of 35%. The yields on other debt securities shown in the table above are calculated by dividing annual interest, including accretion of discounts and amortization of premiums, by the amortized cost of the securities at December 31, 2013.

At December 31, 2013 and 2012, the weighted average maturity was 2.3 and 2.6 years, respectively, for debt securities in the available-for-sale portfolio.

At December 31, 2013, the net unrealized gains on securities available-for-sale amounted to $3.9 million. The net unrealized gain or loss on such securities, net of tax, is reflected in accumulated other comprehensive income/loss. The net unrealized gains on securities available-for-sale was $9.3 million at December 31, 2012. For both periods, the net unrealized gain was primarily attributable to a decrease in market rates between the date of purchase and the balance sheet date resulting in higher valuations of the portfolio securities.

For further information regarding our portfolio of securities available-for-sale, see Note 4 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

Securities Held-to-Maturity:

The following table sets forth the carrying value of our portfolio of securities held-to-maturity at December 31 of each of the last three years.

SECURITIES HELD-TO-MATURITY
(In Thousands)

	December 31,		
	2013	2012	2011
State and Municipal Obligations	$198,206	$183,373	$149,688
Mortgage Backed Securities - Residential	100,055	55,430	—
Corporate and Other Debt Securities	1,000	1,000	1,000
Total	$299,261	$239,803	$150,688

39

For a description of the various categories of securities held in the securities held-to-maturity portfolio on the reporting dates, see the paragraph under "SECURITIES AVAILABLE-FOR-SALE" table, above.

For information regarding the fair value of our portfolio of securities held-to-maturity at December 31, 2013, see Note 4 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

The following table sets forth the maturities of our portfolio of securities held-to-maturity as of December 31, 2013.

MATURITIES OF DEBT SECURITIES HELD-TO-MATURITY
(In Thousands)

	Within One Year	After 1 But Within 5 Years	After 5 But Within 10 Years	After 10 Years	Total
State and Municipal Obligations	$43,043	$82,001	$69,832	$3,330	$198,206
Mortgage Backed Securities - Residential	—	41,958	58,097	—	100,055
Corporate and Other Debt Securities	—	—	—	1,000	1,000
Total	$43,043	$123,959	$127,929	$4,330	$299,261

The following table sets forth the tax-equivalent yields of our portfolio of securities held-to-maturity at December 31, 2013.

YIELDS ON SECURITIES HELD-TO-MATURITY
(Fully Tax-Equivalent Basis)

	Within One Year		After 1 But Within 5 Years		After 5 But Within 10 Years		After 10 Years		Total	
State and Municipal Obligations	1.90	%	3.22	%	4.77	%	6.19	%	3.53	%
Mortgage Backed Securities - Residential	—		1.55		2.55		—		2.13	
Corporate and Other Debt Securities	—		—		—		7.00		7.00	
Total	1.90		2.13		2.60		6.38		2.36	

The yields shown in the table above are calculated by dividing annual interest, including accretion of discounts and amortization of premiums, by the amortized cost of the securities at December 31, 2013. Yields on obligations of states and municipalities exempt from federal taxation (which constituted the entire portfolio) were computed on a fully tax-equivalent basis using a marginal tax rate of 35%.

The weighted-average maturity of the held-to-maturity portfolio was 3.5 and 3.2 years at year-end December 31, 2013 and 2012, respectively.

II. LOAN PORTFOLIO

The amounts and respective percentages of loans outstanding represented by each principal category on the dates indicated were as follows:

a. Types of Loans
(Dollars In Thousands)

	December 31, 2013		2012		2011		2010		2009	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial	$87,893	7	$105,536	9	$99,791	9	$97,621	8	$89,222	8
Commercial Real Estate – Construction	27,815	2	29,149	2	11,083	1	7,090	1	15,336	1
Commercial Real Estate – Other	288,119	23	245,177	21	232,149	21	214,291	19	185,582	17
Consumer – Other	7,649	1	6,684	1	6,318	1	6,482	1	11,981	1
Consumer – Automobile	394,204	31	349,100	30	322,375	28	334,656	29	317,854	29
Residential Real Estate	460,792	36	436,695	37	459,741	40	485,368	42	492,175	44
Total Loans	1,266,472	100	1,172,341	100	1,131,457	100	1,145,508	100	1,112,150	100
Allowance for Loan Losses	(14,434	)	(15,298	)	(15,003	)	(14,689	)	(14,014	)
Total Loans, Net	$1,252,038		$1,157,043		$1,116,454		$1,130,819		$1,098,136	

Maintenance of High Quality in the Loan Portfolio: In late 2010 and through 2011, residential property values continued to weaken in most of the market areas served by us, and this trend continued for most of 2012, although during the last part of 2012 and 2013 the decline appeared to be slowing or even reversing itself, at least in some of our markets. Some analysts currently are speculating that a "bottom" may have been established in the real estate markets nationwide, including in our service areas, both in terms of price and quantity of transactions, but the evidence is still inconclusive.

The weakness in the asset portfolios of many financial institutions remains a serious concern, offset somewhat by the recent firming up in some real estate markets and significant increase in the equity markets experienced in 2013. Regardless, many lending institutions large and small continue to suffer from a lingering weakness in large portions of their existing loan portfolios as well as by limited opportunities for secure and profitable expansion of their portfolios. For many reasons, including our conservative credit underwriting standards, we largely avoided the negative impact on asset quality that many other banks suffered during the financial crisis. From the start of the crisis through the date of this Report, we have not experienced a significant deterioration in our loan portfolios. In general, we underwrite our residential real estate loans to secondary market standards for prime loans. We have never engaged in subprime mortgage lending as a business line. We never extended or purchased any so-called "Alt-A", "negative amortization", "option ARM", or "negative equity" mortgage loans. On occasion we have made loans to borrowers having a FICO score of 650 or below, where special circumstances justify doing so, or have had extensions of credit outstanding to borrowers who have developed credit problems after origination resulting in deterioration of their FICO scores.

We also on occasion have extended community development loans to borrowers whose creditworthiness is below our normal standards as part of the community support program we have developed in fulfillment of our statutorily-mandated duty to support low and moderate-income borrowers within our service area. However, we are a

prime lender and apply prime lending standards and this, together with the fact that the service area in which we make most of our loans did not experience as severe a decline in property values or economic conditions generally as other parts of the U.S., are the principal reasons that we did not experience significant deterioration during the crisis in our loan portfolio, including the real estate categories of our loan portfolio.
However, like all other banks we operate in an environment where identifying opportunities for secure and profitable expansion of our loan portfolio remains challenging, where competition is intense, and where margins are very tight. If the U.S. economy and our regional economy continue to experience only slow and halting growth or no growth, our individual borrowers will presumably continue to proceed cautiously in taking on new or additional debt, as many small businesses are operating on very narrow margins and many families continue to live on very tight budgets. That is, many of our customers, like U.S. borrowers generally, may continue to pursue overall strategies of cautious de-leveraging in upcoming periods. This trend, combined with our conservative underwriting standards, may result in our continuing to experience only modest loan portfolio growth or even no growth. Moreover, if the U.S. economy or our regional economy worsens, which we think unlikely but possible, we may experience elevated charge-offs, higher provisions to our loan loss reserve, and increasing expense related to asset maintenance and supervision.

Residential Real Estate Loans: In recent years, residential real estate and home equity loans have represented the largest single segment of our loan portfolio (comprising approximately 36% of the entire portfolio at December 31, 2013), eclipsing both automobile loans (31% of the portfolio) and our commercial and commercial real estate loans (32%). Our gross originations for residential real estate loans (including refinancings of mortgage loans) were $118.9 million, $109.1 million and $75.0 million for the years 2013, 2012, and 2011, respectively. During each of these years, these origination totals have significantly exceeded the sum of repayments and prepayments of such loans previously in the portfolio, but we have also sold significant portions of these

originations (typically, more than half) in the secondary market. primarily to Freddie Mac, as rates on conventional real estate mortgages generally continued to fall during this period. Such sales amounted to $48.5 million for 2011, $59.9 million for 2012 and $48.8 million for 2013. If the current low-rate environment for newly originated residential real estate loans persists, we may continue to sell a significant portion of our loan originations and, as a result, may even experience a decrease in our outstanding balances in this segment of our portfolio. Moreover, if our local economy or real estate market suffers further major downturns, the demand for residential real estate loans in our service area may decrease, which also may negatively impact our real estate portfolio and our financial performance.
The Federal Reserve began to wind down its quantitative easing program in early 2014, but the uptick in long-term interest rates, began with the Federal Reserve comments in May 2013 to the effect that the Fed expected to begin winding down this program in the not-too-distant future. This tapering has had the predicted effect of increasing mortgage rates generally in ensuing periods, for all durations and types of mortgage loans, although to the date of this Report the increases in rates have been halting and modest. If in fact this development persists, as is anticipated by some commentators, it may at some point have a significant impact, possibly negative, on the number of home loans, the pricing of such loans, and the pricing of homes themselves in our service area and nationwide, and thus may have a significant impact, possibly negative, on our mortgage lending business and on our financial results generally. While economic conditions have generally improved, leading to the Fed's tapering, management is not able to predict at this point when, or even if, mortgage rates or interest rates generally will experience a meaningful and substantial increase in upcoming periods, or what the overall effect of such an increase would be on our mortgage loan portfolio or our loan portfolio generally, or on our net interest income, net income or financial results, in such periods.

Automobile Loans (primarily through indirect lending): At December 31, 2013, our automobile loans (primarily loans originated through dealerships located primarily in upstate New York) represented nearly a third of loans in our portfolio, and continue to be a significant component of our business.
During portions of 2012, and particularly during 2013, there was a nationwide resurgence in automobile sales, due in the view of many to an aging fleet and a modest resurgence in consumer optimism. Although our automobile loan volume for 2012 was very strong at $194.0 million, originations for 2013 exceeded that level at $218.0 million.
Net charge-offs on automobile loans for 2013 were $175 thousand, or $26 thousand below the net charge-offs for 2012. Our experienced lending staff not only utilizes credit evaluation software tools but also reviews and evaluates each loan individually. We believe our disciplined approach to evaluating risk has contributed to maintaining our strong loan quality in this portfolio. If weakness in auto demand returns, however, our portfolio is likely to experience limited, if any, overall growth, either in real terms or as a percentage of the total portfolio, regardless of whether the auto company affiliates are offering highly-subsidized loans. Although recently somewhat improved, customer demand for vehicle loans is still well below pre-crisis levels and if demand does not continue to improve, neither will our financial performance in this important loan category.

Commercial, Commercial Real Estate and Construction and Land Development Loans: Over the last decade, we have experienced moderate and occasionally strong demand for commercial and commercial real estate loans. These loan balances have generally increased, both in dollar amount and as a percentage of the overall loan portfolio, and this segment of our portfolio was the segment least affected by the 2008-2009 crisis. In 2013, commercial and commercial real estate loan growth was significant as outstanding balances increased by $24.0 million over the December 31, 2012 level. Growth was restrained somewhat by heightened competition for credits in an extremely low rate environment.
Substantially all commercial and commercial real estate loans in our portfolio were extended to businesses or borrowers located in our regional markets. Many of the loans in the commercial portfolio have variable rates tied to prime, FHLBNY rates or U.S. Treasury indices. Although on a national scale the commercial real estate market suffered a major downturn in the 2008-2009 period from which it has not yet fully recovered, we have not experienced any significant weakening in the quality of our commercial loan portfolio in recent years.
It is entirely possible that we may experience a reduction in the demand for commercial and commercial real estate loans and/or a weakening in the quality of our portfolio in upcoming periods. Generally, however, the business sector,

at least in our service areas, appeared to be in reasonably good financial condition at period-end.

42

The following table indicates the changing mix in our loan portfolio by including the quarterly average balances for our significant loan products for the past five quarters. The remaining quarter-by-quarter tables present the percentage of total loans represented by each category and the annualized tax-equivalent yield of each category.

LOAN PORTFOLIO
Quarterly Average Loan Balances
(Dollars In Thousands)

	Quarters Ended				
	Dec 2013	Sep 2013	Jun 2013	Mar 2013	Dec 2012
Commercial and Commercial Real Estate	$397,503	$386,973	$379,533	$381,281	$366,761
Residential Real Estate	322,080	316,582	305,222	308,091	314,583
Home Equity	99,722	94,726	91,339	88,926	87,124
Consumer Loans - Automobile	408,273	398,329	380,993	363,120	361,723
Other Consumer Loans[1]	27,379	28,230	27,954	28,452	30,035
Total Loans	$1,254,957	$1,224,840	$1,185,041	$1,169,870	$1,160,226

Percentage of Total Quarterly Average Loans

	Quarters Ended									
	Dec 2013		Sep 2013		Jun 2013		Mar 2013		Dec 2012	
Commercial and Commercial Real Estate	31.7	%	31.6	%	32.0	%	32.6	%	31.6	%
Residential Real Estate	25.6		25.9		25.7		26.4		27.1	
Home Equity	8.0		7.7		7.7		7.6		7.5	
Consumer Loans - Automobile	32.5		32.5		32.2		31.0		31.2	
Other Consumer Loans[1]	2.2		2.3		2.4		2.4		2.6	
Total Loans	100.0	%	100.0	%	100.0	%	100.0	%	100.0	%

Quarterly Tax-Equivalent Yield on Loans

	Quarters Ended									
	Dec 2013		Sep 2013		Jun 2013		Mar 2013		Dec 2012	
Commercial and Commercial Real Estate	4.65	%	4.52	%	4.61	%	4.74	%	4.91	%
Residential Real Estate	4.53		4.62		4.75		4.93		5.00	
Home Equity	2.94		2.98		3.00		3.03		3.03	
Consumer Loans - Automobile	3.54		3.68		3.83		3.97		4.18	
Other Consumer Loans[1]	5.72		5.96		5.97		6.16		6.24	
Total Loans	4.15		4.18		4.30		4.46		4.60	

[1] Other Consumer Loans includes certain home improvement loans secured by mortgages. However, these same loan balances are reported as
Residential Real Estate in the table of period-end balances on page 41, captioned “Types of Loans.”

As the yield table above indicates, average rates across our portfolio have steadily declined over the last 5 quarters, in direct response to the Fed's maintaining historically low interest rates in its attempt to re-energize the economy, coupled with a general moderation of loan demand on the part of corporate and individual customers.
For the fourth quarter of 2013 the average yield on our loan portfolio declined by 45 basis points from the fourth quarter of 2012, from 4.60% to 4.15%. The decrease was exacerbated by extremely competitive pressures on rates for new commercial and commercial real estate loans as well as automobile loans and the decreasing rate environment generally. The yields on new 30 year fixed-rate residential real estate loans (the choice of most of our mortgage

customers) remained very low during the quarter, so we continued to sell many of those originations to the secondary market, specifically, to Freddie Mac.
As average yields on the portfolio were dropping in 2013, our margins were also compressing. The decrease in average yield on our loan portfolio of 45 basis points was 27 basis points greater than the 18 basis point decline in our average cost of deposits from the last quarter of 2012 to the last quarter of 2013. We expect that average loan yields will continue to decline in 2014, and at a faster rate than our average cost of deposits, with the result that margins too may continue to diminish.
In general, the yield (tax-equivalent interest income divided by average loans) on our loan portfolio and other earning assets has historically been impacted by changes in prevailing interest rates, as previously discussed in this Report beginning on page 31 under the heading "Impact of Interest Rate Changes." We expect that such will continue to be the case; that is, that loan yields will continue to rise and fall with changes in prevailing market rates, although the timing and degree of responsiveness will be influenced by a variety of other factors, including the extent of federal government and Federal Reserve participation in the home mortgage market, the makeup of our loan portfolio, the shape of the yield curve, consumer expectations and preferences, and the rate at which the portfolio expands. Additionally, there is a significant amount of cash flow from normal amortization and prepayments in all loan categories, and this cash flow reprices at current rates as new loans are generated at the current yields. Thus, even if prevailing rates remain flat or even increase slightly in upcoming periods, our average rate on our portfolio may continue to decline

as older credits in our portfolio bearing generally higher rates continue to mature and roll over or are redeployed into lower priced loans.
The following table indicates the respective maturities and interest rate structure of our commercial and commercial real estate construction loans at December 31, 2013. For purposes of determining relevant maturities, loans are assumed to mature at (but not before) their scheduled repayment dates as required by contractual terms. Demand loans and overdrafts are included in the “Within 1 Year” maturity category. Most of the commercial construction loans are made with a commitment for permanent financing, whether extended by us or unrelated third parties. The maturity distribution below reflects the final maturity of the permanent financing.

b. Maturities and Sensitivities of Loans to Changes in Interest Rates
(In Thousands)

	Within 1 Year	After 1 But Within 5 Years	After 5 Years	Total
Commercial	$27,121	$51,047	$9,725	$87,893
Commercial Real Estate - Construction	9,166	3,027	15,622	27,815
Total	$36,287	$54,074	$25,347	$115,708
Fixed Interest Rates	$1,726	$31,017	$22,153	$54,896
Variable Interest Rates	34,560	23,057	3,194	60,811
Total	$36,286	$54,074	$25,347	$115,707

COMMITMENTS AND LINES OF CREDIT
Stand-by letters of credit represent extensions of credit granted in the normal course of business, which are not reflected in the financial statements at a given date because the commitments are not funded at that time. As of December 31, 2013, our total contingent liability for standby letters of credit amounted to $3.3 million. In addition to these instruments, we also have issued lines of credit to customers, including home equity lines of credit, commitments for residential and commercial construction loans and other personal and commercial lines of credit, which also may be unfunded or only partially funded from time-to-time. Commercial lines, generally issued for a period of one year, are usually extended to provide for the working capital requirements of the borrower. At December 31, 2013, we had outstanding unfunded loan commitments in the aggregate amount of approximately $237.9 million.

c. Risk Elements

1. Nonaccrual, Past Due and Restructured Loans
The amounts of nonaccrual, past due and restructured loans for the past five years are presented in the table on page 34 under the heading "Summary of the Allowance and Provision for Loan Losses".
Loans are placed on nonaccrual status either due to the delinquency status of principal and/or interest or a judgment by management that the full repayment of principal and interest is unlikely. Unless already placed on nonaccrual status, loans secured by home equity lines of credit are put on nonaccrual status when 120 days past due; residential real estate loans when 150 days past due; commercial and commercial real estate loans are evaluated on a loan-by-loan basis and are placed on nonaccrual status when 90 days past due if the full collection of principal and interest is uncertain. Under the Uniform Retail Credit Classification and Account Management Policy established by banking regulators, fixed-maturity consumer loans not secured by real estate must generally be charged-off no later than when 120 days past due. Loans secured with non-real estate collateral in the process of collection are charged-down to the value of the collateral, less cost to sell. Open-end credits, residential real estate loans and commercial loans are evaluated for charge-off on a loan-by-loan basis when placed on nonaccrual status. We had no material commitments to lend additional funds on outstanding nonaccrual loans at December 31, 2013. Loans past due 90 days or more and

still accruing interest are those loans which were contractually past due 90 days or more but because of expected repayments, were still accruing interest.

The balance of loans 30-89 days past due totaled $8.3 million at December 31, 2013 and represented 0.65% of loans outstanding at that date, as compared to approximately $8.5 million, or 0.72% of loans at December 31, 2012. These non-current loans at December 31, 2013 were composed of approximately $4.3 million of consumer loans, principally indirect automobile loans, $1.7 million of residential real estate loans and $2.3 million of commercial and commercial real estate loans.

We evaluate nonaccrual loans over $250 thousand and all troubled debt restructured loans individually for impairment. All our impaired loans are measured based on either (i) the present value of expected future cash flows discounted at the loan's effective interest rate, (ii) the loan's observable market price or (iii) the fair value of the collateral, less cost to sell, if the loan is collateral dependent. We determine impairment for collateralized loans based on the fair value of the collateral less estimated cost to sell. For other impaired loans, impairment is determined by comparing the recorded value of the loan to the present value of the expected cash flows, discounted at the loan's effective interest rate. We determine the interest income recognition method for impaired loans on a loan-by-loan basis. Based upon the borrowers' payment histories and cash flow projections, interest recognition methods include full accrual or cash basis. Our method for measuring all other loans is described in detail in Notes 2 and 5 to the consolidated financial statements.

The loan note to the consolidated financial statements, i.e., Note 5 (beginning on page 70) contains detailed information on modified loans and impaired loans.

2. Potential Problem Loans

On at least a quarterly basis, we re-evaluate our internal credit quality rating for commercial loans that are either past due or fully performing but exhibit certain characteristics that could reflect a potential weakness. Loans are placed on nonaccrual status when the likely amount of future principal and interest payments are expected to be less than the contractual amounts, even if such loans are not past due.

Periodically we review the loan portfolio for evidence of potential problem loans. Potential problem loans are loans that are currently performing in accordance with contractual terms, but where known information about possible credit problems of the borrower causes doubt about the ability of the borrower to comply with the loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. In our credit monitoring program, we treat loans that are classified as substandard but continue to accrue interest as potential problem loans. At December 31, 2013, we identified 172 commercial loans totaling $25.4 million as potential problem loans. At December 31, 2012, we identified 175 commercial loans totaling $24.5 million as potential problem loans. For these loans, although positive factors such as payment history, value of supporting collateral, and/or personal or government guarantees led us to conclude that accounting for them as non-performing at year-end was not warranted, other factors, specifically, certain risk factors related to the loan or the borrower justified concerns that they may become nonperforming at some point in the future.

The overall level of our performing loans that demonstrate characteristics of potential weakness from time-to-time is for the most part dependent on economic conditions in northeastern New York State, which in turn are generally impacted at least in part by economic conditions in the U.S. On both the regional and national level, economic conditions are generally improved over the 2009-2010 period, but are much weaker than was the case in 2007 and earlier periods. If weak or stagnant economic conditions persist, potential problem loans likely will continue at their present levels or increase.

3. Foreign Outstandings - None

4. Loan Concentrations

The loan portfolio is well diversified. There are no concentrations of credit that exceed 10% of the portfolio, other than the general categories reported in the preceding Section C.II.a. of this Item 7. For further discussion, see Note 1 to the Consolidated Financial Statements in Part II, Item 8 of this Report.

5. Other Real Estate Owned and Repossessed Assets

Other real estate owned ("OREO") primarily consists of real property acquired in foreclosure. OREO is carried at fair value less estimated cost to sell. We establish allowances for OREO losses, which are determined and monitored on a property-by-property basis and reflect our ongoing estimate of the property's estimated fair value less costs to sell. For all periods, all OREO was held for sale. Repossessed assets for each of the five years in the table below consist of motor vehicles.

Distribution of OREO and Repossessed Assets (In Thousands)	December 31,				
	2013	2012	2011	2010	2009
Single Family 1 - 4 Units	$41	$552	$310	$—	$53
Commercial Real Estate	40	418	150	—	—
Other Real Estate Owned, Net	81	970	460	—	53
Repossessed Assets	63	64	56	58	59
Total OREO and Repossessed Assets	$144	$1,034	$516	$58	$112

The following table summarizes changes in the net carrying amount of OREO and the number of properties for each of the periods presented.

Schedule of Changes in OREO (In Thousands)	2013	2012	2011	2010	2009
Balance at Beginning of Year	$970	$460	$—	$53	$581
Properties Acquired Through Foreclosure	392	950	409	—	54
Transfer of Bank Property	—	—	150	—	—
Sales	(1,281)	(440)	(99)	(53)	(582)
Balance at End of Year	$81	$970	$460	$—	$53
Number of Properties, Beginning of Year	7	5	—	1	4
Properties Acquired During the Year	1	7	6	—	1
Properties Sold During the Year	(6)	(5)	(1)	(1)	(4)
Number of Properties, End of Year	2	7	5	—	1

There was no allowance for OREO losses at year-end 2013, 2012 or 2011.

III. SUMMARY OF LOAN LOSS EXPERIENCE

The information required in this section is presented in the discussion of the "Provision for Loan Losses and Allowance for Loan Losses" in Part II Item 7.B.II. beginning on page 34 of this Report, including:

- Charge-offs and Recoveries by loan type
- Factors that led to the amount of the Provision for Loan Losses
- Allocation of the Allowance for Loan Losses by loan type

The percent of loans in each loan category is presented in the table of loan types in the preceding section on page 41 of this report.

IV. DEPOSITS
The following table sets forth the average balances of and average rates paid on deposits for the periods indicated.

AVERAGE DEPOSIT BALANCES
(Dollars In Thousands)

	Years Ended December 31,								
	2013			2012			2011		
	Average Balance	Rate		Average Balance	Rate		Average Balance	Rate	
Demand Deposits	$264,959	—	%	$240,872	—	%	$221,035	—	%
NOW Accounts	798,230	0.31		726,660	0.49		603,965	0.84	
Savings Deposits	490,558	0.21		437,095	0.29		409,398	0.46	
Time Deposits of $100,000 or More	86,457	1.39		107,665	1.86		122,897	2.14	
Other Time Deposits	179,997	1.09		212,918	1.75		238,865	2.15	
Total Deposits	$1,820,201	0.37		$1,725,210	0.61		$1,596,160	1.07	

During 2013 average deposit balances, in total, increased by $95.0 million, or 5.5%, over the average for 2012. Most of this growth occurred in the fourth quarter of 2013. The increase was generated from our pre-existing branch network, although we did open two new branches, one in Queensbury, New York and the other in Clifton Park, New York.
During 2012 average deposit balances, in total, increased by $129.1 million, or 8.1%, over the average for 2011. As in 2013, a significant amount of the 2012 deposit growth occurred in the fourth quarter. The increase was generated from our pre-existing branch network.
During 2011 average deposit balances, in total, increased by $104.6 million, or 7.0%, over the average for 2010. The increase was generated from our pre-existing branch network.
We did not sell or close any branches during the covered period, 2011-2013. We did not hold any brokered deposits during 2013, 2012 and 2011.

The following table presents the quarterly average balance by deposit type for each of the most recent five quarters.

DEPOSIT PORTFOLIO
Quarterly Average Deposit Balances
(Dollars In Thousands)

	Quarters Ended				
	Dec 2013	Sep 2013	Jun 2013	Mar 2013	Dec 2012

Demand Deposits	$279,967	$277,381	$254,642	$247,347	$249,176
NOW Accounts	855,106	749,654	796,330	791,669	798,513
Savings Deposits	517,542	509,014	479,480	455,311	444,603
Time Deposits of $100,000 or More	81,804	85,757	87,059	91,322	95,742
Other Time Deposits	170,503	178,375	183,835	187,477	193,744
Total Deposits	$1,904,922	$1,800,181	$1,801,346	$1,773,126	$1,781,778

Fluctuations in balances of our NOW accounts and time deposits of $100,000 or more are largely the result of municipal deposit fluctuations. Municipal deposits on average represent 26% to 33% of our total deposits. Municipal deposits are typically placed in NOW accounts and time deposits of short duration. Many of our municipal deposit relationships are subject to annual renewal, by formal or informal agreements.

We typically experience a shift within the mix of deposit categories during periods of significant interest rate increases or decreases. During periods of falling rates and very low rates, such as the period from mid-2007 through the end of 2013, depositors tend to transfer maturing time deposits to nonmaturity interest-bearing deposit products. This trend continued during 2013. At

46

December 31, 2013 time deposits represented 13.4% of total deposits, down from 16.4% at December 31, 2012. This year-end 2013 level for time deposits was below the low point in the last falling interest rate cycle, when, at June 30, 2004, the ratio was 22.5%, and compares to a high ratio of 40.8% at June 30, 2000. We expect this shift from time deposits to nonmaturity deposit products to continue, although perhaps at a slower pace, if deposit rates and interest rates generally remain at their current extraordinarily low levels. Contrarily, if deposit rates begin to climb, we anticipate the movement of time deposits to nonmaturity interest bearing deposits to slow, halt altogether or reverse itself at some point.

In general, there is a seasonal pattern to municipal deposits which dip to a low point during July and August. Account balances tend to increase throughout the fall and into the winter months from tax deposits and increase again at the end of March from the electronic deposit of NYS Aid payments to school districts. In addition to these seasonal fluctuations within types of accounts, the overall level of municipal deposit balances fluctuates from year-to-year as some municipalities move their accounts in and out of our banks due to competitive factors. Often, the balances of municipal deposits at the end of a quarter are not representative of the average balances for that quarter.

For a variety of reasons, including the seasonality of municipal deposits, we typically experience little net growth or a small contraction in average deposit balances in the first quarter of each calendar year, some growth in the second quarter, contraction in the third quarter and substantial growth in the fourth quarter. Deposit balances followed this general pattern for 2013, enhanced by the addition of new municipal account relationships throughout the year. We also experienced growth in our non-municipal account balances, primarily in NOW accounts and money market savings accounts.

The total quarterly average balances as a percentage of total deposits are illustrated in the table below.

Percentage of Total Quarterly Average Deposits	Quarters Ended									
	Dec 2013		Sep 2013		Jun 2013		Mar 2013		Dec 2012	
Demand Deposits	14.7	%	15.4	%	14.2	%	13.9	%	14.0	%
NOW Accounts	44.8		41.6		44.2		44.6		44.8	
Savings Deposits	27.2		28.3		26.6		25.7		24.9	
Time Deposits of $100,000 or More	4.3		4.8		4.8		5.2		5.4	
Other Time Deposits	9.0		9.9		10.2		10.6		10.9	
Total Deposits	100.0	%	100.0	%	100.0	%	100.0	%	100.0	%

Time deposits of $100,000 or more are to a large extent comprised of municipal deposits and are typically obtained on a competitive bid basis. We, like virtually all insured depository institutions, have experienced a steady decrease in the cost of our deposits over each of the past 5 quarters mirroring and continuing the protracted period of falling interest rates extending from mid-2007 through the end of 2013. Although some maturing time deposits will continue to reprice at lower rates in forthcoming periods, the favorable reduction in the cost of deposits may come to a halt in the mid- or near-term future, since most of our time deposits have already repriced to current rates and the rates on our nonmaturity deposit balances have already been reduced to (or nearly to) the lowest sustainable levels. The total quarterly cost of deposits are illustrated in the table below:

Quarterly Cost of Deposits	Quarters Ended									
	Dec 2013		Sep 2013		Jun 2013		Mar 2013		Dec 2012	
Demand Deposits	—	%	—	%	—	%	—	%	—	%
NOW Accounts	0.22		0.22		0.40		0.40		0.43	
Savings Deposits	0.18		0.19		0.23		0.24		0.25	

Time Deposits of $100,000 or More	1.34	1.37	1.41	1.42	1.54
Other Time Deposits	1.01	1.05	1.10	1.20	1.34
Total Deposits	0.30	0.32	0.42	0.44	0.48

In general, rates paid by us on various types of deposit accounts are influenced by the rates being offered or paid by our competitors, which in turn are influenced by prevailing interest rates in the economy as impacted from time-to-time by the actions of the Federal Reserve Bank. There typically is a time lag between the Federal Reserve’s actions undertaken to influence rates and the actual repricing of our deposit liabilities, although this lag is normally shorter than the lag between Federal Reserve rate actions and the repricing of our loans and other earning assets.

We do not use brokered deposits as a regular funding source and there were not any such balances carried during 2013, 2012 or 2011.

The maturities of time deposits of $100,000 or more at December 31, 2013 are presented below. (In Thousands)

Maturing in:	
Under Three Months	$19,896
Three to Six Months	13,181
Six to Twelve Months	20,923
2015	8,192
2016	4,474
2017	5,994
2018	4,761
2019	1,507
Total	$78,928

V. SHORT-TERM BORROWINGS

	2013		2012		2011	
Overnight Advances from the Federal Home Loan Bank of New York, Federal Funds Purchased and Securities Sold Under Agreements to Repurchase:						
Balance at December 31	$64,777		$41,678		$68,293	
Maximum Month-End Balance	64,777		41,678		93,988	
Average Balance During the Year	33,322		24,225		54,750	
Average Rate During the Year	0.27	%	0.18	%	0.17	%
Rate at December 31	0.28	%	0.25	%	0.23	%
Other Short-Term Borrowings:						
Balance at December 31	$—		$—		$—	
Maximum Month-End Balance	—		—		2,211	
Average Balance During the Year	—		—		1,456	
Average Rate During the Year	—	%	—	%	—	%
Rate at December 31	—	%	—	%	—	%
Average Aggregate Short-Term Borrowing Rate During the Year	0.27	%	0.18	%	0.16	%

D. LIQUIDITY

The objective of effective liquidity management is to ensure that we have the ability to raise cash when we need it at a reasonable cost. We must be capable of meeting expected and unexpected obligations to our customers at any time. Given the uncertain nature of customer demands as well as the need to maximize earnings, we must have available reasonably priced sources of funds, both on- and off-balance sheet, that can be accessed quickly in time of need.

Our primary sources of available liquidity are overnight investments in federal funds sold, interest bearing bank balances at the Federal Reserve Bank, and cash flow from investment securities and loans. Certain investment securities are selected at purchase as available-for-sale based on their marketability and collateral value, as well as their yield and maturity. Our securities available-for-sale portfolio was $457.6 million at year-end 2013, a decrease of $21.1 million from the year-end 2012 level. Due to the potential for volatility in market values, we are not always able to assume that securities may be sold on short notice at their carrying value, even to provide needed liquidity.

In addition to liquidity from short-term investments, investment securities and loans, we have supplemented available operating liquidity with additional off-balance sheet sources such as federal funds lines of credit and credit lines with the Federal Home Loan Bank of New York ("FHLBNY"). Our federal funds lines of credit are with three correspondent banks totaling $30 million, but we only drew on these lines once during 2013.

To support our borrowing relationship with the FHLBNY, we have pledged collateral, including mortgage-backed securities and residential mortgage loans. Our unused borrowing capacity at the FHLBNY was approximately $214 million at December 31, 2013. In addition we have identified brokered certificates of deposit as an appropriate off-balance sheet source of funding accessible in a relatively short time period. Also, our two bank subsidiaries have each established a borrowing facility with the Federal Reserve Bank of Net York, pledging certain consumer loans as collateral for potential "discount window" advances, which we maintain for contingency liquidity purposes. At December 31, 2013, the amount available under this facility was approximately $302 million, but there were no advances then outstanding.

We measure and monitor our basic liquidity as a ratio of liquid assets to total short-term liabilities, both with and without the availability of borrowing arrangements. Based on the level of overnight funds investments, available liquidity from our investment securities portfolio, cash flows from our loan portfolio, our stable core deposit base and our significant borrowing capacity, we believe that our liquidity is sufficient to meet all funding needs that may arise in connection with any reasonably likely events or occurrences. At December 31, 2013, our basic liquidity ratio was 6.9% of total assets, or $148 million, well above our minimum ratio as defined in policy of 4%, or $87 million of total assets.

Because of Arrow's favorable credit quality and strong balance sheet, Arrow did not experience any significant liquidity constraints through the date of this report and was never forced to pay premium rates to obtain retail deposits or other funds from any source.

E. CAPITAL RESOURCES AND DIVIDENDS

Important Changes to Regulatory Capital Standards

New Bank Regulatory Capital Standards.

The Dodd-Frank Act directed U.S. bank regulators to promulgate new bank capital standards, which would be at least as strict as the regulatory capital standards in effect at the time Dodd-Frank was enacted in 2010. The new bank regulatory capital standards were adopted in 2013 and will be effective for Arrow and our subsidiary banks beginning in 2015. These new rules are summarized in an earlier section of this Report, "Supervision and Regulation--Regulatory Capital Standards--New Bank Regulatory Capital Standards," pages 7-9.

Current Bank Regulatory Capital Standards

The current bank regulatory capital standards for banks and bank holding companies will gradually be replaced by the new standards recently adopted by the regulators, which will become effective for us beginning on January 1, 2015. The current regulatory capital standards are discussed above under "Regulation and Supervision--Regulatory Capital Standards--Current Bank Regulatory Capital Standards."
Our holding company and our subsidiary banks are currently subject to two sets of regulatory capital measures, risk-based capital guidelines and a leverage ratio test. The risk-based guidelines assign risk weightings to all assets and certain off-balance sheet items of financial institutions, which generally results in a substantial discounting of low-risk or risk-free assets, that is, a significant dollar amount of such assets disappears from the balance sheet. The guidelines then establish an 8% minimum ratio of qualified total capital to risk-weighted assets. At least half of total capital must consist of "Tier 1" capital, which comprises common equity and common equity equivalents, retained earnings, a limited amount of permanent preferred stock and (for holding companies) a limited amount of trust preferred securities (see the discussion below on these securities), less intangible assets, net of associated deferred tax liabilities. Up to half of total capital may consist of so-called "Tier 2" capital, comprising a limited amount of subordinated debt, other preferred stock, certain other instruments and a limited amount of the allowance for loan losses.
The second regulatory capital measure, the leverage ratio test, establishes minimum limits on the ratio of Tier 1 capital to total tangible assets, without risk weighting (i.e. discounting). For top-rated companies, the minimum leverage ratio currently is 4%, but lower-rated or rapidly expanding companies may be required by bank regulators to meet substantially higher minimum leverage ratios. Federal banking law mandates certain actions to be taken by banking regulators for financial institutions that are deemed undercapitalized as measured under regulatory capital guidelines. The law establishes five levels of capitalization for financial institutions ranging from "well-capitalized” (the highest ranking) to "critically undercapitalized" (the lowest ranking). Federal banking law also ties the ability of banking organizations to engage in certain types of non-banking financial activities to such organizations' continuing to qualify as "well-capitalized" under these standards.

Capital Ratios: The table below sets forth the capital ratios of our holding company and subsidiary banks, Glens Falls National and Saratoga National, as of December 31, 2013, as determined under the current bank regulatory capital standards:

Capital Ratios:	Arrow		GFNB		SNB	
Tier 1 Leverage Ratio	9.2	%	8.8	%	9.7	%

Tier 1 Risk-Based Capital Ratio	14.7 %	14.4 %	13.7 %
Total Risk-Based Capital Ratio	15.8 %	15.4 %	14.8 %

At December 31, 2013 our holding company and both banks exceeded the minimum current regulatory capital ratios, and qualified as "well-capitalized", the highest category, in the capital classification scheme set by federal bank regulatory agencies.

Stockholders' Equity at Year-end 2013: Stockholders' equity was $192.2 million at December 31, 2013, an increase of $16.3 million, or 9.3%, from the prior year-end. The most significant positive changes to stockholders' equity included (a) net income of $21.8 million, (b) equity received from our various stock-based compensation plans of $3.2 million, (c) other comprehensive income of $4.1 million, offset, in part by (d) cash dividends of $12.1 million, and (e) purchases of our own common stock of $1.7 million.

Trust Preferred Securities: In each of 2003 and 2004, we issued $10 million of trust preferred securities (TRUPs) in a private placement. Under the Federal Reserve Board's pre-existing rules on regulatory capital, TRUPs typically would qualify as Tier 1 capital for bank holding companies such as ours but only in amounts up to 25% of Tier 1 capital, net of goodwill less any associated deferred tax liability. Under the Dodd-Frank Act, trust preferred securities issued by Arrow on or after the grandfathering date set forth in Dodd-Frank (May 19, 2010) will no longer qualify as Tier 1 capital under bank regulatory capital guidelines; however, our TRUPs outstanding prior to the grandfathering cutoff date set forth in Dodd-Frank (May 19, 2010) may continue to qualify as Tier 1 capital until maturity or redemption, subject to limitations.

49

Dividends: The source of funds for the payment of stockholder dividends by our holding company consists primarily of dividends declared and paid to the holding company by our bank subsidiaries. In addition to indirect regulatory limitations on payments of dividends by our holding company (i.e., the need to maintain adequate regulatory capital), there are statutory limitations applicable to the payment of dividends by our bank subsidiaries to our holding company. As of December 31, 2013, under this statutory limitation, the maximum amount that could have been paid by the bank subsidiaries to the holding company, without special regulatory approval, was approximately $26.7 million. The ability of our holding company and our banks to pay dividends in the future is and will continue to be influenced by regulatory policies, capital guidelines and applicable laws.
See Part II, Item 5, "Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" for a recent history of our cash dividend payments.

Stock Repurchase Program: In November 2012, the Board of Directors approved a $5.0 million stock repurchase program, effective January 1, 2013 (the 2013 program), under which management was authorized, in its discretion, to repurchase from time-to-time during 2013, in the open market or in privately negotiated transactions, up to $5 million of Arrow common stock, to the extent management believed the Company's stock was reasonably priced and such repurchases appeared to be an attractive use of available capital and in the best interests of stockholders. As of December 31, 2013, approximately $1.3 million had been used under the 2013 Program to repurchase shares. In November 2103, the Board of Directors authorized a similar $5.0 million stock repurchase program, effective for calendar year 2014.

F. OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of operations, we may engage in a variety of financial transactions or arrangements, including derivative transactions or arrangements, that in accordance with generally accepted accounting principles are not recorded in the financial statements, or are recorded in amounts that differ from the notional amounts. These transactions or arrangements involve, to varying degrees, elements of credit, interest rate, and liquidity risk. Such transactions or arrangements may be used by us or our customers for general corporate purposes, such as managing credit, interest rate, or liquidity risk or to optimize capital, or may be used by us or our customers to manage funding needs.
We have no off-balance sheet arrangements that are reasonably likely to have a material current or future effect on our financial condition, revenues or expenses, results of operations, liquidity or capital expenditures. As of December 31, 2013, we had no derivative securities, including interest rate swaps, credit default swaps, or equity puts or calls, in our investment portfolio.

G. CONTRACTUAL OBLIGATIONS (In Thousands)

	Payments Due by Period				
Contractual Obligation	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Long-Term Debt Obligations:					
Federal Home Loan Bank Advances [1]	$20,000	$10,000	$10,000	$—	$—
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts [2]	20,000	—	—	—	20,000
Operating Lease Obligations [3]	2,733	638	1,023	624	448
Obligations under Retirement Plans [4]	45,337	4,030	6,317	6,318	28,672
Total	$88,070	$14,668	$17,340	$6,942	$49,120

[1] See Note 10 to the Consolidated Financial Statements in Item 8 of this Report for additional information on Federal Home Loan Bank Advances, including call provisions.
[2] See Note 10 to the Consolidated Financial Statements in Item 8 of this Report for additional information on Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts (trust preferred securities).
[3] See Note 18 to the Consolidated Financial Statements in Item 8 of this Report for additional information on our Operating Lease Obligations.
[4] See Note 13 to the Consolidated Financial Statements in Item 8 of this Report for additional information on our Retirement Benefit Plans.

50

H. FOURTH QUARTER RESULTS

We reported net income of $5.8 million for the fourth quarter of 2013, an increase of $235 thousand, or 4.2%, from the fourth quarter of 2012. Diluted earnings per common share for the fourth quarter of 2013 were $.47, an increase of $.02, or 4.4%, from the $.45 amount for the fourth quarter of 2012. The net change in earnings between the two quarters was primarily affected by the following: (a) a $636 thousand increase in tax-equivalent net interest income, (b) a $20 thousand decrease in noninterest income (including a $156 thousand decrease in net securities gains), (c) a $175 thousand decrease in the provision for loan losses, (d) a $268 thousand increase in noninterest expense, and (e) a $161 thousand increase in the provision for income taxes. The principal factors contributing to these quarter-to-quarter changes are included in the discussion of the year-to-year changes in net income set forth elsewhere in this Item 7, specifically, in Section B, "Results of Operations," above, as well as in the Company's Current Report on Form 8-K, as filed with the SEC on January 21, 2014, incorporating by reference the Company's earnings release for the year ended December 31, 2013.

SELECTED FOURTH QUARTER FINANCIAL INFORMATION
(Dollars In Thousands, Except Per Share Amounts)

	For the Quarters Ended December 31,			
	2013		2012	
Interest and Dividend Income	$16,459		$16,740	
Interest Expense	1,713		2,503	
Net Interest Income	14,746		14,237	
Provision for Loan Losses	—		175	
Net Interest Income after Provision for Loan Losses	14,746		14,062	
Noninterest Income	6,877		6,897	
Noninterest Expense	13,385		13,117	
Income Before Provision for Income Taxes	8,238		7,842	
Provision for Income Taxes	2,454		2,293	
Net Income	$5,784		$5,549	
SHARE AND PER SHARE DATA:				
Weighted Average Number of Shares Outstanding:				
Basic	12,339		12,254	
Diluted	12,387		12,273	
Basic Earnings Per Common Share	$0.47		0.45	
Diluted Earnings Per Common Share	0.47		0.45	
Cash Dividends Per Common Share	0.25		0.25	
AVERAGE BALANCES:				
Assets	$2,176,264		$2,064,602	
Earning Assets	2,064,578		1,945,441	
Loans	1,254,957		1,160,226	
Deposits	1,904,922		1,781,778	
Stockholders' Equity	184,506		176,514	
SELECTED RATIOS (Annualized):				
Return on Average Assets	1.05	%	1.07	%
Return on Average Equity	12.44	%	12.51	%
Net Interest Margin [1]	3.06	%	3.13	%

Net Charge-offs to Average Loans	0.05	%	0.04	%
Provision for Loan Losses to Average Loans	—	%	0.06	%

[1] Net Interest Margin is the ratio of tax-equivalent net interest income to average earning assets. (See “Use of Non-GAAP Financial
Measures” on page 4).

51

SUMMARY OF QUARTERLY FINANCIAL DATA (Unaudited)
The following quarterly financial information for 2013 and 2012 is unaudited, but, in the opinion of management, fairly presents the results of Arrow.

SELECTED QUARTERLY FINANCIAL DATA
(In Thousands, Except Per Share Amounts)

	2013 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total Interest and Dividend Income	$15,996	$15,809	$15,874	$16,459
Net Interest Income	13,757	13,586	14,127	14,746
Provision for Loan Losses	100	100	—	—
Net Securities Gains	527	13	—	—
Income Before Provision for Income Taxes	7,420	7,283	7,933	8,238
Net Income	5,181	5,207	5,623	5,784
Basic Earnings Per Common Share	0.42	0.42	0.46	0.47
Diluted Earnings Per Common Share	0.42	0.42	0.46	0.47

	2012 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Total Interest and Dividend Income	$17,938	$17,533	$17,168	$16,740
Net Interest Income	14,406	14,254	14,525	14,237
Provision for Loan Losses	280	240	150	175
Net Securities Gains	502	143	64	156
Income Before Provision for Income Taxes	7,539	8,171	8,288	7,842
Net Income	5,288	5,594	5,748	5,549
Basic Earnings Per Common Share	0.43	0.46	0.47	0.45
Diluted Earnings Per Common Share	0.43	0.46	0.47	0.45

Item 7A. Quantitative and Qualitative Disclosures About Market Risk
In addition to credit risk in our loan portfolio and liquidity risk, discussed earlier, our business activities also generate market risk. Market risk is the possibility that changes in future market rates (interest rates) or prices (fees for products and services) will make our position (i.e., our assets and operations) less valuable. The ongoing monitoring and management of interest rate and market risk is an important component of our asset/liability management process, which is governed by policies that are reviewed and approved annually by the Board of Directors. The Board of Directors delegates responsibility for carrying out asset/liability oversight and control to management's Asset/Liability Committee ("ALCO"). In this capacity ALCO develops guidelines and strategies impacting our asset/liability profile based upon estimated market risk sensitivity, policy limits and overall market interest rate levels and trends. We have not made use of derivatives, such as interest rate swaps, in our risk management process.
Interest rate risk is the most significant market risk affecting us. Interest rate risk is the exposure of our net interest income to changes in interest rates. Interest rate risk is directly related to the different maturities and repricing characteristics of interest-bearing assets and liabilities, as well as to the risk of prepayment of loans and early withdrawal of time deposits, and the fact that the speed and magnitude of responses to interest rate changes varies by

product.

ALCO utilizes the results of a detailed and dynamic simulation model to quantify the estimated exposure of net interest income to sustained interest rate changes. While ALCO routinely monitors simulated net interest income sensitivity over a rolling two-year horizon, it also utilizes additional tools to monitor potential longer-term interest rate risk, including periodic stress testing involving hypothetical sudden and significant interest rate spikes.

Our standard simulation model attempts to capture the impact of changing interest rates on the interest income received and interest expense paid on all interest-sensitive assets and liabilities reflected on our consolidated balance sheet. This sensitivity analysis is compared to ALCO policy limits which specify a maximum tolerance level for net interest income exposure over a one- year horizon, assuming no balance sheet growth and a 200 basis point upward and a 100 basis point downward shift in interest rates, and a repricing of interest-bearing assets and liabilities at their earliest reasonably predictable repricing date. We normally apply a parallel and pro rata shift in rates over a 12 month period. However, at year-end 2013 the targeted federal funds rate remained where it had been since late 2008, a range of 0 to .25%, with inferences from the Fed that this rate and other short-term rates would remain at or near their current historically low rates at least through year-end 2014. Moreover, our average cost of deposits for 2013 had decreased to a record low of 0.43%. Thus, for purposes of our decreasing rate simulation, we applied a

52

hypothetical 100 basis point downward shift in interest rates for assets and liabilities at the long end of the yield curve with hypothetical short-term rate decreases for particular assets and liabilities equal to the lesser of 100 basis points or such lower rate (below 100 basis points) as was actually borne by such asset or liability.

Applying the simulation model analysis as of December 31, 2013, a 200 basis point increase in interest rates demonstrated a 7.9% decrease in net interest income, and a 100 basis (as adjusted) decrease in interest rates demonstrated a 1.0% decrease in net interest income. These amounts were within our ALCO policy limits.

Historically there has existed an inverse relationship between changes in prevailing rates and our net interest income, reflecting the fact that our liabilities and sources of funds generally reprice more quickly than our earning assets. However, when current prevailing interest rates are already extremely low, a further decline in prevailing rates may not produce the otherwise expected increase in net interest income, even over a relatively short time horizon, because as noted above, further decreases in rates with respect to liabilities (deposits) may be significantly impeded by the absolute lower boundary of the zero rate, no matter how quickly they reprice, whereas further decreases in asset rates are not as likely to run up against the absolute lower boundary of zero, and thus may be experienced in full or nearly full, across the asset portfolio, even if assets reprice more slowly than liabilities. Thus, even in the short run, rate decreases in the current environment may not be beneficial to income.

This explains the abnormal result of our simulation model, above, i.e., that over the indicated time horizon of 12 months, an assumed increase in prevailing rates projects a decrease in our net interest income, as might normally be expected (due to assets repricing more slowly than liabilities), while at the same time, an assumed decrease in prevailing rates also projects a decrease, if a smaller decrease, in our net interest income, presumably due to the zero rate boundary factor.

Moreover, if the impact of rate change on our income is projected over a longer time horizon, e.g., two years or longer, it might be expected that a decrease in prevailing rates would have a greater negative impact on our income, as compared to the short-term result, as assets continue to reprice downward in full response, while liabilities do not further reprice but remain trapped by the absolute zero rate boundary. On the other hand, an increase in prevailing rates would have a much less negative impact over the longer term, and perhaps even a neutral or positive impact, on our net interest income, as our asset portfolios eventually reprice upward fully to match the repricing of our liabilities. However, other factors may play a significant role in any analysis of the impact of rising rates on our income, including a possible softening of loan demand and/or slowing of the economy that might be expected to accompany any general rate rise.

The preceding sensitivity analysis does not represent a forecast on our part and should not be relied upon as being indicative of expected operating results.

We continue to believe that, in a normalized rate environment, (i.e., a positively sloped yield curve) any downturn in prevailing interest rates will generally have a short-term positive impact on our net interest margin and net interest income, which would be mitigated or perhaps reversed over the mid- to longer-term of ensuing rate decreases. We also believe an upturn in prevailing rates will generally have a short-term negative impact on our margin and net interest income, which again would likely be mitigated or perhaps reversed as rates continue to rise over the medium- or long-term. We believe that, whether rates are generally increasing, decreasing or stable, changes in the slope of the yield curve will also affect net interest income and the net interest margin. Other things being equal, a more sharply sloping (upward) yield curve will generally have a positive impact on our net interest income and interest margin, whereas a flattening of the yield curve will generally have a negative impact. We are not able to predict with certainty what the magnitude of these effects taken together-that is, changes in rates, plus changes in the yield curve-would be in any particular case, especially if changes in rate and curve, taken independently, would normally work against each other (e.g., lower rates, combined with a flattening yield curve).

The hypothetical estimates underlying the sensitivity analysis are based upon numerous assumptions including: the nature and timing of changes in interest rates including yield curve shape, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment/replacement of asset and liability cash flows, and others. While assumptions are developed based upon current economic and local market conditions, we cannot make any assurance as to the predictive nature of these assumptions including how customer preferences or competitor influences might change.

Also, as market conditions vary from those assumed in the sensitivity analysis, actual results will differ due to: prepayment/refinancing levels likely deviating from those assumed, the varying impact of interest rate changes on caps or floors on adjustable rate assets, the potential effect of changing debt service levels on customers with adjustable rate loans, depositor early withdrawals and product preference changes, unanticipated shifts in the yield curve and other internal/external variables. Furthermore, the sensitivity analysis does not reflect actions that ALCO might take in responding to or anticipating changes in interest rates.

Item 8. Financial Statements and Supplementary Data

The following audited consolidated financial statements and unaudited supplementary data are submitted herewith:

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Arrow Financial Corporation:

We have audited the accompanying consolidated balance sheets of Arrow Financial Corporation and subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2013. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arrow Financial Corporation and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 14, 2014, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Albany, New York
March 14, 2014

54

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Arrow Financial Corporation:

We have audited Arrow Financial Corporation and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control—Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Arrow Financial Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control—Integrated Framework (1992) issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Arrow Financial Corporation and subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013, and our report dated March 14, 2014 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Albany, New York
March 14, 2014

55

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share and Per Share Amounts)

	December 31, 2013	December 31, 2012
ASSETS		
Cash and Due From Banks	$37,275	$37,076
Interest-Bearing Deposits at Banks	12,705	11,756
Investment Securities:		
Available-for-Sale	457,606	478,698
Held-to-Maturity (Approximate Fair Value of $302,305 at December 31, 2013 and $248,252 at December 31, 2012)	299,261	239,803
Federal Home Loan Bank and Federal Reserve Bank Stock	6,281	5,792
Loans	1,266,472	1,172,341
Allowance for Loan Losses	(14,434)	(15,298)
Net Loans	1,252,038	1,157,043
Premises and Equipment, Net	29,154	28,897
Goodwill	22,003	22,003
Other Intangible Assets, Net	4,140	4,492
Other Assets	43,235	37,236
Total Assets	$2,163,698	$2,022,796
LIABILITIES		
Noninterest-Bearing Deposits	$278,958	$247,232
NOW Accounts	817,366	758,287
Savings Deposits	498,779	442,363
Time Deposits of $100,000 or More	78,928	93,375
Other Time Deposits	168,299	189,898
Total Deposits	1,842,330	1,731,155
Short-Term Borrowings	64,777	41,678
Federal Home Loan Bank Term Advances	20,000	30,000
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000
Other Liabilities	24,437	24,138
Total Liabilities	1,971,544	1,846,971
STOCKHOLDERS’ EQUITY		
Preferred Stock, $5 Par Value; 1,000,000 Shares Authorized	—	—
Common Stock, $1 Par Value; 20,000,000 Shares Authorized (16,744,486 Shares Issued at December 31, 2013 and 16,416,163 Shares Issued at December 31, 2012)	16,744	16,416
Additional Paid-in Capital	229,290	218,650
Retained Earnings	27,457	26,251
Unallocated ESOP Shares (87,641 Shares at December 31, 2013 and 102,890 Shares at December 31, 2012)	(1,800)	(2,150)
Accumulated Other Comprehensive Loss	(4,373)	(8,462)
Treasury Stock, at Cost (4,296,723 Shares at December 31, 2013 and 4,288,617 Shares at December 31, 2012)	(75,164)	(74,880)
Total Stockholders’ Equity	192,154	175,825
Total Liabilities and Stockholders’ Equity	$2,163,698	$2,022,796

See Notes to Consolidated Financial Statements.

56

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In Thousands, Except Per Share Amounts)

	Years Ended December 31,		
	2013	2012	2011
INTEREST AND DIVIDEND INCOME			
Interest and Fees on Loans	$51,319	$54,511	$58,599
Interest on Deposits at Banks	89	108	99
Interest and Dividends on Investment Securities:			
Fully Taxable	6,903	9,269	12,402
Exempt from Federal Taxes	5,827	5,491	5,691
Total Interest and Dividend Income	64,138	69,379	76,791
INTEREST EXPENSE			
NOW Accounts	2,461	3,564	5,052
Savings Deposits	1,024	1,287	1,898
Time Deposits of $100,000 or More	1,198	2,007	2,633
Other Time Deposits	1,962	3,730	5,143
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	18	22	74
Federal Home Loan Bank Advances	680	729	3,295
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	579	618	584
Total Interest Expense	7,922	11,957	18,679
NET INTEREST INCOME	56,216	57,422	58,112
Provision for Loan Losses	200	845	845
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	56,016	56,577	57,267
NONINTEREST INCOME			
Income From Fiduciary Activities	6,735	6,290	6,113
Fees for Other Services to Customers	9,407	8,245	8,034
Insurance Commissions	8,895	8,247	7,374
Net Gain on Securities Transactions	540	865	2,795
Net Gain on Sales of Loans	1,460	2,282	866
Other Operating Income	1,024	1,170	746
Total Noninterest Income	28,061	27,099	25,928
NONINTEREST EXPENSE			
Salaries and Employee Benefits	31,182	31,703	30,205
Occupancy Expenses, Net	8,285	7,467	7,369
FDIC Assessments	1,080	1,026	1,292
Prepayment Penalty on FHLB Advances	—	—	1,638
Other Operating Expense	12,656	11,640	11,044
Total Noninterest Expense	53,203	51,836	51,548
INCOME BEFORE PROVISION FOR INCOME TAXES	30,874	31,840	31,647
Provision for Income Taxes	9,079	9,661	9,714
NET INCOME	$21,795	$22,179	$21,933
Average Shares Outstanding:			
Basic	12,296	12,247	12,209
Diluted	12,327	12,257	12,221
Per Common Share:			

Basic Earnings	$1.77	$1.81	$1.80
Diluted Earnings	1.77	1.81	1.79

Share and Per Share Amounts have been restated for the September 2013 2% stock dividend.
See Notes to Consolidated Financial Statements.

57

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In Thousands)

	Years Ended December 31,		
	2013	2012	2011
Net Income	$21,795	$22,179	$21,933
Other Comprehensive Income (Loss), Net of Tax:			
Unrealized Net Securities Holding (Losses) Gains Arising During the Year	(2,925)	(661)	4,741
Reclassification Adjustment for Net Securities Gains Included in Net Income	(326)	(522)	(1,688)
Net Retirement Plan Gain (Loss)	6,425	(1,340)	(3,701)
Net Retirement Plan Prior Service (Cost) Credit	—	(245)	(161)
Amortization of Net Retirement Plan Actuarial Loss	914	1,013	602
Accretion of Net Retirement Plan Prior Service Credit	1	(12)	(65)
Other Comprehensive (Loss) Income	4,089	(1,767)	(272)
Comprehensive Income	$25,884	$20,412	$21,661

See Notes to Consolidated Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(In Thousands, Except Share and Per Share Amounts)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Unallo-cated ESOP Shares	Accumu-lated Other Com-prehensive Income (Loss)	Treasury Stock	Total
Balance at December 31, 2010	$15,626	$191,068	$24,577	$ (2,876)	$ (6,423)	$(69,713)	$152,259
Net Income	—	—	21,933	—	—	—	21,933
Other Comprehensive (Loss) Income	—	—	—	—	(272)	—	(272)
3% Stock Dividend (468,765 Shares)	468	10,647	(11,115)	—	—	—	—
Cash Dividends Paid, $.94 per Share [1]	—	—	(11,448)	—	—	—	(11,448)
Shares Issued for Stock Option Exercises, net (72,802 Shares)	—	705	—	—	—	708	1,413
Shares Issued Under the Directors' Stock Plan (7,456 Shares)	—	104	—	—	—	71	175
Shares Issued Under the Employee Stock Purchase Plan (20,484 Shares)	—	282	—	—	—	192	474
Shares Issued for Dividend Reinvestment Plans (76,447 Shares)	—	1,062	—	—	—	734	1,796
Stock-Based Compensation Expense	—	354	—	—	—	—	354
Tax Benefit for Exercises of Stock Options	—	51	—	—	—	—	51
Purchase of Treasury Stock (251,962 Shares)	—	—	—	—	—	(6,039)	(6,039)
Acquisition of Subsidiary (221,517 Shares)	—	3,275	—	—	—	1,986	5,261
Allocation of ESOP Stock (18,216 Shares)	—	52	—	376	—	—	428
Balance at December 31, 2011	$16,094	$207,600	$23,947	$ (2,500)	$ (6,695)	$(72,061)	$166,385
Balance at December 31, 2011	$16,094	$207,600	$23,947	$ (2,500)	$ (6,695)	$(72,061)	$166,385
Net Income	—	—	22,179	—	—	—	22,179
Other Comprehensive (Loss) Income	—	—	—	—	(1,767)	—	(1,767)
2% Stock Dividend (321,886 Shares)	322	7,738	(8,060)	—	—	—	—
Cash Dividends Paid, $.97 per Share [1]	—	—	(11,815)	—	—	—	(11,815)

Shares Issued for Stock Option Exercises, net (96,471 Shares)	—	1,152	—	—	—	953	2,105
Shares Issued Under the Directors' Stock Plan (7,226 Shares)	—	104	—	—	—	71	175
Shares Issued Under the Employee Stock Purchase Plan (20,687 Shares)	—	279	—	—	—	205	484
Shares Issued for Dividend Reinvestment Plans (74,260 Shares)	—	1,086	—	—	—	736	1,822
Stock-Based Compensation Expense	—	424	—	—	—	—	424
Tax Benefit for Exercises of Stock Options	—	68	—	—	—	—	68
Purchase of Treasury Stock (199,323 Shares)	—	—	—	—	—	(4,877)	(4,877)
Acquisition of Subsidiaries (9,356 Shares)	—	140	—	—	—	93	233
Allocation of ESOP Stock (16,629 Shares)	—	59	—	350	—	—	409
Balance at December 31, 2012	$16,416	$218,650	$26,251	$(2,150)	$(8,462)	$(74,880)	$175,825

59

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY, Continued
(In Thousands, Except Share and Per Share Amounts)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Unallo-cated ESOP Shares	Accumu-lated Other Com-prehensive Income (Loss)	Treasury Stock	Total
Balance at December 31, 2012	$16,416	$218,650	$26,251	$ (2,150)	$ (8,462)	$(74,880)	$175,825
Net Income	—	—	21,795	—	—	—	21,795
Other Comprehensive (Loss) Income	—	—	—	—	4,089	—	4,089
2% Stock Dividend (328,323 Shares) [2]	328	8,152	(8,480)	—	—	—	—
Cash Dividends Paid, $.99 per Share [1]	—	—	(12,109)	—	—	—	(12,109)
Shares Issued for Stock Option Exercises, net (58,719 Shares)	—	676	—	—	—	578	1,254
Shares Issued Under the Directors' Stock Plan (7,643 Shares)	—	123	—	—	—	75	198
Shares Issued Under the Employee Stock Purchase Plan (19,679 Shares)	—	283	—	—	—	194	477
Shares Issued for Dividend Reinvestment Plans (49,574 Shares)	—	796	—	—	—	484	1,280
Stock-Based Compensation Expense	—	372	—	—	—	—	372
Tax Benefit for Exercises of Stock Options	—	23	—	—	—	—	23
Purchase of Treasury Stock (68,361 Shares)	—	—	—	—	—	(1,709)	(1,709)
Acquisition of Subsidiaries (9,503 Shares)	—	139	—	—	—	94	233
Allocation of ESOP Stock (16,969 Shares)	—	76	—	350	—	—	426
Balance at December 31, 2013	$16,744	$229,290	$27,457	$ (1,800)	$ (4,373)	$(75,164)	$192,154

[1] Cash dividends paid per share have been adjusted for the September 2013 2% stock dividend.
[2] Included in the shares issued for the 2% stock dividend in 2013 were treasury shares of 84,863 and unallocated ESOP shares of 1,720.

See Notes to Consolidated Financial Statements.

60

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)

	Years Ended December 31,		
Cash Flows from Operating Activities:	2013	2012	2011
Net Income	$21,795	$22,179	$21,933
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Provision for Loan Losses	200	845	845
Depreciation and Amortization	8,870	8,856	6,509
Allocation of ESOP Stock	426	409	428
Gains on the Sale of Securities Available-for-Sale	(527)	(949)	(2,795)
Gains on the Sale of Securities Held-to-Maturity	(18)	—	—
Losses on the Sale of Securities Available-for-Sale	—	84	—
Losses on the Sale of Securities Held-to-Maturity	5	—	—
Loans Originated and Held-for-Sale	(46,101)	(60,668)	(39,111)
Proceeds from the Sale of Loans Held-for-Sale	50,298	61,041	49,378
Net Gains on the Sale of Loans	(1,460)	(2,282)	(866)
Net Losses (Gains) on the Sale of Premises and Equipment, Other Real Estate Owned and Repossessed Assets	120	(71)	(32)
Contributions to Pension Plans	(473)	(328)	(5,319)
Deferred Income Tax Expense (Benefit)	294	(353)	2,172
Shares Issued Under the Directors' Stock Plan	198	175	175
Stock-Based Compensation Expense	372	424	354
Net Decrease in Other Assets	1,888	2,108	1,725
Net Increase in Other Liabilities	786	990	689
Net Cash Provided By Operating Activities	36,673	32,460	36,085
Cash Flows from Investing Activities:			
Proceeds from the Sale of Securities Available-for-Sale	16,295	58,718	39,009
Proceeds from the Maturities and Calls of Securities Available-for-Sale	132,228	210,224	280,126
Purchases of Securities Available-for-Sale	(136,416)	(197,029)	(354,310)
Proceeds from the Sale of Securities Held-to-Maturity	1,181	—	—
Proceeds from the Maturities and Calls of Securities Held-to-Maturity	47,228	49,983	40,692
Purchases of Securities Held-to-Maturity	(109,620)	(140,635)	(31,701)
Net (Increase) Decrease in Loans	(98,903)	(40,951)	3,108
Proceeds from the Sales of Premises and Equipment, Other Real Estate Owned and Repossessed Assets	1,789	1,263	770
Purchase of Premises and Equipment	(2,233)	(8,073)	(5,372)
Cash Paid for Subsidiaries, Net	(75)	(75)	(3,296)
Net (Increase) Decrease in Federal Home Loan Bank Stock	(489)	930	1,880
Purchase of Bank Owned Life Insurance	—	—	(15,702)
Net Cash Used In Investing Activities	(149,015)	(65,645)	(44,796)
Cash Flows from Financing Activities:			
Net Increase in Deposits	111,175	87,109	110,042
Net Increase (Decrease) in Short-Term Borrowings	23,099	(26,615)	15,079
Federal Home Loan Bank Advances	—	—	10,000
Repayments of Federal Home Loan Bank Advances	(10,000)	(10,000)	(100,000)
Purchase of Treasury Stock	(1,709)	(4,877)	(6,039)
Shares Issued for Stock Option Exercises, net	1,254	2,105	1,413

Shares Issued Under the Employee Stock Purchase Plan	477	484	474
Tax Benefit for Exercises of Stock Options	23	68	51
Shares Issued for Dividend Reinvestment Plans	1,280	1,822	1,796
Cash Dividends Paid	(12,109)	(11,815)	(11,448)
Net Cash Provided By Financing Activities	113,490	38,281	21,368
Net Increase in Cash and Cash Equivalents	1,148	5,096	12,657
Cash and Cash Equivalents at Beginning of Year	48,832	43,736	31,079
Cash and Cash Equivalents at End of Year	$49,980	$48,832	$43,736
Supplemental Disclosures to Statements of Cash Flow Information:			
Interest on Deposits and Borrowings	$8,067	$12,520	$19,490
Income Taxes	8,336	8,866	7,952
Non-cash Investing and Financing Activity:			
Transfer of Loans to Other Real Estate Owned and Repossessed Assets	971	1,426	1,011
Shares Issued for Acquisition of Subsidiary	233	233	5,261
Fair Value of Assets from Acquisition of Subsidiary	—	—	10,638
Fair Value of Liabilities from Acquisition of Subsidiary	—	—	2,081

See Notes to Consolidated Financial Statements.

61

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: RISKS AND UNCERTAINTIES

Nature of Operations - Arrow Financial Corporation, a New York corporation, was incorporated on March 21, 1983 and is registered as a bank holding company within the meaning of the Bank Holding Company Act of 1956. Arrow derives most of its earnings from the ownership of two nationally chartered commercial banks and through the ownership of four insurance agencies. The two banks provide a full range of services to individuals and small to mid-size businesses in northeastern New York State from just north of Albany, the State's capitol, to the Canadian border. Both banks have trust departments which provide investment management and administrative services. The insurance agencies specialize in property and casualty insurance, group health insurance, sports accident and health insurance, and individual life insurance.

Management’s Use of Estimates - The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting period. Our most significant estimates are the allowance for loan losses, the evaluation of other-than-temporary impairment of investment securities, goodwill impairment, pension and other postretirement liabilities, analysis of a need for a valuation allowance for deferred tax assets and other fair value calculations. Actual results could differ from those estimates.
A material estimate that is particularly susceptible to significant change in the near term is the allowance for loan losses. The allowance for loan losses is management’s best estimate of probable loan losses incurred as of the balance sheet date. While management uses available information to recognize losses on loans, future adjustments to the allowance for loan losses may be necessary based on changes in economic conditions.

Concentrations of Credit - Virtually all of Arrow's loans are with customers in upstate New York. Although the loan portfolios of the subsidiary banks are well diversified, tourism has a substantial impact on the northeastern New York economy. The commitments to extend credit are fairly consistent with the distribution of loans presented in Note 5, generally have the same credit risk and are subject to normal credit policies. Generally, the loans are secured by assets and are expected to be repaid from cash flow or the sale of selected assets of the borrowers. Arrow evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by Arrow upon extension of credit, is based upon management's credit evaluation of the counterparty. The nature of the collateral varies with the type of loan and may include: residential real estate, cash and securities, inventory, accounts receivable, property, plant and equipment, income producing commercial properties and automobiles.

Note 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation - The financial statements of Arrow and its wholly owned subsidiaries are consolidated and all material inter-company transactions have been eliminated. In the “Parent Company Only” financial statements in Note 20, the investment in wholly owned subsidiaries is carried under the equity method of accounting. When necessary, prior years’ consolidated financial statements have been reclassified to conform to the current-year financial statement presentation.

Segment Reporting - Arrow operations are primarily in the community banking industry, which constitutes Arrow’s only segment for financial reporting purposes. Arrow provides other services, such as trust administration, retirement plan administration, advice to our proprietary mutual funds and insurance products, but these services do not rise to the quantitative thresholds for separate disclosure. Arrow operates primarily in the northeastern region of New York

State in Warren, Washington, Saratoga, Essex and Clinton counties and surrounding areas.

Cash and Cash Equivalents - Cash and cash equivalents include the following items: cash at branches, due from bank balances, cash items in the process of collection, interest-bearing bank balances and federal funds sold.

Securities - Management determines the appropriate classification of securities at the time of purchase. Securities reported as held-to-maturity are those debt securities which Arrow has both the positive intent and ability to hold to maturity and are stated at amortized cost. Securities available-for-sale are reported at fair value, with unrealized gains and losses reported in accumulated other comprehensive income or loss, net of taxes. Realized gains and losses are based upon the amortized cost of the specific security sold. A decline in the fair value of any available-for-sale or held-to-maturity security below cost that is deemed to be other-than-temporary results in an impairment to reduce the carrying amount to fair value. To determine whether an impairment is other-than-temporary, we consider all available information relevant to the collectibility of the security, including past events, current conditions, and reasonable and supportable forecasts when developing an estimate of cash flows expected to be collected. Evidence considered in this assessment includes the reasons for impairment, the severity and duration of the impairment, changes in value subsequent to year-end, forecasted performance of the investee, and the general market condition in the geographic area or industry the investee operates in. When an other-than-temporary impairment has occurred on a debt security, the amount of the other-than-temporary impairment recognized in earnings depends on whether we intend to sell the debt security or more likely than not will be required to sell the debt security before recovery of its amortized cost basis less any current-period credit loss. If we intend to sell the debt security or it is more likely than not that we will be required to sell the debt security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If we do not intend to sell the debt security and it is not more likely than not that we will be required to sell the debt security before recovery of its amortized cost basis, the other-than-temporary impairment is separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to other factors is recognized in other comprehensive income, net of applicable income taxes.

Loans and Allowance for Loan Losses - Interest income on loans is accrued and credited to income based upon the principal amount outstanding. Loan fees and costs directly associated with loan originations are deferred and amortized/accreted as an adjustment to yield over the lives of the loans originated.

From time-to-time, Arrow has sold (most with servicing retained) residential real estate loans at or shortly after origination. Any gain or loss on the sale of loans, along with the value of the servicing right, is recognized at the time of sale as the difference between the recorded basis in the loan and net proceeds from the sale. Loans held for sale are recorded at the lower of cost or fair value on an aggregate basis.

Loans are placed on nonaccrual status either due to the delinquency status of principal and/or interest or a judgment by management that the full repayment of principal and interest is unlikely. Unless already placed on nonaccrual status, loans secured by home equity lines of credit are put on nonaccrual status when 120 days past due; residential real estate loans when 150 days past due; commercial and commercial real estate loans are evaluated on a loan-by-loan basis and are placed on nonaccrual status when 90 days past due if the full collection of principal and interest is uncertain. The balance of any accrued interest deemed uncollectible at the date the loan is placed on nonaccrual status is reversed, generally against interest income. A loan is returned to accrual status at the later of the date when the past due status of the loan falls below the threshold for nonaccrual status or management deems that it is likely that the borrower will repay all interest and principal. For payments received while the loan is on nonaccrual status, we may recognize interest income on a cash basis if the repayment of the remaining principal and accrued interest is deemed likely.

The allowance for loan losses is maintained by charges to operations based upon our best estimate of the probable amount of loans that we will be unable to collect based on current information and events. Provisions to the allowance for loan losses are offset by actual loan charge-offs (net of any recoveries). We evaluate the loan portfolio for potential charge-offs on a monthly basis. In general, automobile and other consumer loans are charged-off when 120 days delinquent. Residential real estate loans are charged-off when a loss becomes known or based on a new appraisal at the earlier of 180 days past due or repossession. Commercial and commercial real estate loans loans are evaluated early in their delinquency status and are charged-off when management concludes that not all principal will be repaid from on-going cash flows or liquidation of collateral. An evaluation of estimated proceeds from the liquidation of the loan's collateral is compared to the loan carrying amount and a charge to the allowance for loan losses is taken for any deficiency. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions in Arrow's market area. In addition, various Federal regulatory agencies, as an integral part of their examination process, review Arrow's allowance for loan losses. Such agencies may require Arrow to recognize additions to the allowance in future periods, based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

We consider nonaccrual loans over $250 thousand and all troubled debt restructured loans to be impaired loans and we evaluate these loans individually to determine the amount of impairment, if any. The amount of impairment, if any, related to individual impaired loans is measured based on either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Arrow determines impairment for collateral dependent loans based on the fair value of the collateral less estimated costs to sell. Any excess of the recorded investment in the collateral dependent impaired loan over the estimated collateral value, less costs to sell, is typically charged off. For impaired loans which are not collateral dependent, impairment is measured by comparing the recorded investment in the loan to the present value of the expected cash flows, discounted at the loan's effective interest rate. If this amount is less than the recorded investment in the loan, an impairment reserve is recognized as part of the allowance for loan losses, or based upon the judgment of management all or a portion of the excess of the recorded investment in the loan over the present value of the estimated future cash flow may be charged off.

The allowance for loan losses on the remaining loans is primarily determined based upon consideration of the historical net loss experience of the respective portfolios, adjusted as necessary based upon consideration of qualitative considerations impacting the inherent risk of loss in the respective loan portfolios.

In management's opinion, the balance of the allowance for loan losses, at each balance sheet date, is sufficient to provide for probable loan losses inherent in the corresponding loan portfolio.

Other Real Estate Owned and Repossessed Assets - Real estate acquired by foreclosure and assets acquired by repossession are recorded at the fair value of the property less estimated costs to sell at the time of repossession. Subsequent declines in fair value, after transfer to other real estate owned and repossessed assets are recognized through a valuation allowance. Such declines in fair value along with related operating expenses to administer such properties or assets are charged directly to operating expense.

Premises and Equipment - Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization included in operating expenses are computed largely on the straight-line method. Depreciation is

63

based on the estimated useful lives of the assets (buildings and improvements 20-40 years; furniture and equipment 7-10 years; data processing equipment 5-7 years) and, in the case of leasehold improvements, amortization is computed over the terms of the respective leases or their estimated useful lives, whichever is shorter. Gains or losses on disposition are reflected in earnings.

Income Taxes - Arrow accounts for income taxes under the asset and liability 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. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date. Arrow's policy is that deferred tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

Goodwill and Other Intangible Assets - Identifiable intangible assets acquired in a business combination are capitalized and amortized. Any remaining unidentifiable intangible asset is classified as goodwill, for which amortization is not required but which must be evaluated for impairment. Arrow tests for impairment of goodwill on an annual basis, or when events and circumstances indicate potential impairment. In evaluating goodwill for impairment, Arrow first assesses certain qualitative factors to determine if it is more likely than not that the fair value of the reporting unit is less than its carrying value. If it is more likely than not that the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any.
The carrying amounts of other recognized intangible assets that meet recognition criteria and for which separate accounting records have been maintained (core deposit intangibles and mortgage servicing rights), have been included in the consolidated balance sheet as "Other Intangible Assets, Net." Core deposit intangibles are being amortized on a straight-line basis over a period of ten to fifteen years.
Arrow has sold residential real estate loans, primarily to Freddie Mac, with servicing retained. Mortgage servicing rights are recognized as an asset when loans are sold with servicing retained, by allocating the cost of an originated mortgage loan between the loan and servicing right based on estimated relative fair values. The cost allocated to the servicing right is capitalized as a separate asset and amortized in proportion to, and over the period of, estimated net servicing income. Capitalized mortgage servicing rights are evaluated for impairment by comparing the asset's carrying value to its current estimated fair value. Fair values are estimated using a discounted cash flow approach, which considers future servicing income and costs, current market interest rates, and anticipated prepayment, and default rates. Impairment losses are recognized through a valuation allowance for servicing rights having a current fair value that is less than amortized cost on an aggregate basis. Adjustments to increase or decrease the valuation allowance are charged or credited to income as a component of other operating income.

Pension and Postretirement Benefits - Arrow maintains a non-contributory, defined benefit pension plan covering substantially all employees, a supplemental pension plan covering certain executive officers selected by the Board of Directors, and certain post-retirement medical, dental and life insurance benefits for employees and retirees. The costs of these plans, based on actuarial computations of current and future benefits for employees, are charged to current operating expenses. The cost of post-retirement benefits other than pensions is recognized on an accrual basis as employees perform services to earn the benefits. Arrow recognizes the overfunded or underfunded status of our single employer defined benefit pension plan as an asset or liability on its consolidated balance sheet and recognizes changes in the funded status in comprehensive income in the year in which the change occurred.
Prior service costs or credits are amortized on a straight-line basis over the average remaining service period of active participants. Gains and losses in excess of 10% of the greater of the benefit obligation or the fair value of assets are amortized over the average remaining service period of active participants.

The discount rate assumption is determined by preparing an analysis of the respective plan's expected future cash flows and high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits.

Stock-Based Compensation Plans - Arrow has two stock option plans, which are described more fully in Note 12. The Company expenses the grant date fair value of options granted. The expense is recognized over the vesting period of the grant, typically four years, on a straight-line basis. Shares are generally issued from treasury for the exercise of stock options.
Arrow sponsors an Employee Stock Purchase Plan ("ESPP") under which employees may purchase Arrow's common stock at a 5% discount below market price at the time of purchase. This stock purchase plan is not considered a compensatory plan.
Arrow sponsors an Employee Stock Ownership Plan ("ESOP"), a qualified defined contribution plan. The ESOP has borrowed funds from one of Arrow's subsidiary banks to purchase Arrow common stock. The shares pledged as collateral are reported as a reduction of Arrow's stockholders' equity. Compensation expense is recognized as shares are released for allocation to individual employee accounts equal to the current average market price.

Securities Sold Under Agreements to Repurchase - In securities repurchase agreements, Arrow receives cash from a counterparty in exchange for the transfer of securities to a third party custodian's account that explicitly recognizes Arrow's interest in the securities. These agreements are accounted for by Arrow as secured financing transactions, since it maintains effective control over the transferred securities, and meets other criteria for such accounting. Accordingly, the cash proceeds are recorded as borrowed funds, and the underlying securities continue to be carried in Arrow's securities available-for-sale portfolio.

Earnings Per Share (“EPS”) - Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity (such as Arrow’s stock options), computed using the treasury stock method. Unallocated common shares held by Arrow’s Employee Stock Ownership Plan are not included in the weighted average number of common shares outstanding for either the basic or diluted EPS calculation.

Financial Instruments - Arrow is a party to certain financial instruments with off-balance sheet risk, such as: commercial lines of credit, construction lines of credit, overdraft protection, home equity lines of credit and standby letters of credit. Arrow's policy is to record such instruments when funded. Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time Arrow's entire holdings of a particular financial instrument. Because no market exists for a significant portion of Arrow's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.
Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. For example, Arrow has a trust department that contributes net fee income annually. The value of trust department customer relationships is not considered a financial instrument of the Company, and therefore this value has not been incorporated into the fair value estimates. Other significant assets and liabilities that are not considered financial assets or liabilities include deferred taxes, premises and equipment, the value of low-cost, long-term core deposits and goodwill. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.
The carrying amount of the following short-term assets and liabilities is a reasonable estimate of fair value: cash and due from banks, federal funds sold and purchased, securities sold under agreements to repurchase, demand deposits, savings, N.O.W. and money market deposits, other short-term borrowings, accrued interest receivable and accrued interest payable. The fair value estimates of other on- and off-balance sheet financial instruments, as well as the method of arriving at fair value estimates, are included in the related footnotes and summarized in Note 17.

Fair Value Measures - We determine the fair value of financial instruments under the following hierarchy:

- Level 1 – Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 – Quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 – Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

A financial instrument’s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Management’s Use of Estimates -The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting period. Our most significant estimates are the allowance for loan losses, the evaluation of other-than-temporary impairment of investment securities, goodwill impairment, pension and other postretirement liabilities, analysis of a need for a valuation allowance for deferred tax assets and other fair value calculations. Actual results could differ from those estimates.

A material estimate that is particularly susceptible to significant change in the near term is the allowance for loan losses. In connection with the determination of the allowance for loan losses, management obtains appraisals for properties. The allowance for loan losses is management's best estimate of probable loan losses incurred as of the balance sheet date. While management uses available information to recognize losses on loans, future adjustments to the allowance for loan losses may be necessary based on changes in economic conditions.

65

Recent Accounting Pronouncements

During 2013 the FASB issued twelve accounting standards updates and, through the date of this report, an additional five in 2014. Of the seventeen updates, fourteen did not apply to Arrow.
ASU 2013-02 "Comprehensive Income" requires additional disclosures relating to reclassifications out of accumulated other comprehensive income. The new disclosures are included in Note 5 - Comprehensive Income.
ASU 2013-10 "Derivatives and Hedging" now allows the federal funds effective swap rate as a benchmark interest rate for hedge accounting. While this has no current impact on Arrow, it may provide us an option for future swaps that we did not have before the ASU.
ASU 2014-01 "Investments-Equity Method and Joint Ventures" allows an entity that invests in affordable housing projects that qualify for low-income housing tax credits to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense. The standard is effective for annual years beginning after December 15, 2014, with earlier adoption allowed. We are evaluating the impact of adopting this election and do not expect that this will have a material impact on our financial condition or results of operations.
ASU 2014-04 "Receivables - Trouble Debt Restructurings by Creditors" provides additional guidance on when an in substance repossession or foreclosure occurs and is effective for annual periods beginning after December 15, 2014. We are evaluating the impact of adopting this standard, and we do not expect that it will have a material impact on our financial condition or results of operations.

Note 3: CASH AND CASH EQUIVALENTS (Dollars In Thousands)

The following table is the schedule of cash and cash equivalents at December 31, 2013 and 2012:

	2013	2012
Cash and Due From Banks	$37,275	$37,076
Interest-Bearing Deposits at Banks	12,705	11,756
Total Cash and Cash Equivalents	$49,980	$48,832
Supplemental Information:		
Total required reserves, including vault cash and Federal Reserve Bank deposits	$18,879	$23,168

The Company is required to maintain reserve balances with the Federal Reserve Bank of New York. The required reserve is calculated on a fourteen day average and the amounts presented in the table above represent the average for the period that includes December 31.

Note 4. INVESTMENT SECURITIES (Dollars In Thousands)

The following table is the schedule of Available-For-Sale Securities at December 31, 2013 and 2012:
Available-For-Sale Securities

	U.S. Agency Obligations	State and Municipal Obligations	Mortgage-Backed Securities - Residential	Corporate and Other Debt Securities	Mutual Funds and Equity Securities	Total Available-For-Sale Securities
December 31, 2013						
Available-For-Sale Securities, at Amortized Cost	$136,868	$127,224	$171,321	$17,142	$1,120	$453,675

Available-For-Sale Securities, at Fair Value	136,475	127,389	175,778	16,798	1,166	457,606
Gross Unrealized Gains	2	306	4,714	10	46	5,078
Gross Unrealized Losses	395	141	257	354	—	1,147
Available-For-Sale Securities, Pledged as Collateral						243,769
Maturities of Debt Securities, at Amortized Cost:						
Within One Year	—	48,570	10,920	—		59,490
From 1 - 5 Years	136,868	76,308	146,677	16,142		375,995
From 5 - 10 Years	—	1,666	13,608	—		15,274
Over 10 Years	—	680	116	1,000		1,796

66

Available-For-Sale Securities

	U.S. Agency Obligations	State and Municipal Obligations	Mortgage-Backed Securities - Residential	Corporate and Other Debt Securities	Mutual Funds and Equity Securities	Total Available-For-Sale Securities
Maturities of Debt Securities, at Fair Value:						
Within One Year	—	48,623	11,181	—		59,804
From 1 - 5 Years	136,475	76,405	150,330	15,998		379,208
From 5 - 10 Years	—	1,681	14,146	—		15,827
Over 10 Years	—	680	121	800		1,601
Securities in a Continuous Loss Position, at Fair Value:						
Less than 12 Months	$60,664	$29,967	$15,190	$7,375	$—	$113,196
12 Months or Longer	33,849	4,597	11,841	6,063	—	56,350
Total	$94,513	$34,564	$27,031	$13,438	$—	$169,546
Number of Securities in a Continuous Loss Position	26	107	13	19	—	165
Unrealized Losses on Securities in a Continuous Loss Position:						
Less than 12 Months	$336	$120	$108	$92	$—	$656
12 Months or Longer	59	21	149	262	—	491
Total	$395	$141	$257	$354	$—	$1,147
December 31, 2012						
Available-For-Sale Securities, at Amortized Cost	$122,297	$84,798	$252,480	$8,689	$1,120	$469,384
Available-For-Sale Securities, at Fair Value	122,457	84,838	261,804	8,451	1,148	478,698
Gross Unrealized Gains	204	206	9,405	—	28	9,843
Gross Unrealized Losses	44	166	81	238	—	529
Available-For-Sale Securities, Pledged as Collateral						260,292
Securities in a Continuous Loss Position, at Fair Value:						
Less than 12 Months	$72,531	$46,627	$10,230	$8,451	$—	$137,839
12 Months or Longer	—	2,149	4,968	—	—	7,117
Total	$72,531	$48,776	$15,198	$8,451	$—	$144,956
Number of Securities in a Continuous Loss Position	22	198	7	11	—	238
Unrealized Losses on Securities in a Continuous Loss Position:						
Less than 12 Months	$44	$160	$50	$238	$—	$492

12 Months or Longer	—	6	31	—	—	37
Total	$44	$166	$81	$238	$—	$529

67

The following table is the schedule of Held-To-Maturity Securities at December 31, 2013 and 2012:
Held-To-Maturity Securities

	State and Municipal Obligations	Mortgage-Backed Securities - Residential	Corporate and Other Debt Securities	Total Held-To Maturity Securities
December 31, 2013				
Held-To-Maturity Securities, at Amortized Cost	$198,206	$100,055	$1,000	$299,261
Held-To-Maturity Securities, at Fair Value	202,390	98,915	1,000	302,305
Gross Unrealized Gains	4,762	24	—	4,786
Gross Unrealized Losses	578	1,164	—	1,742
Held-To-Maturity Securities, Pledged as Collateral				298,261
Maturities of Debt Securities, at Amortized Cost:				
Within One Year	43,043	—	—	43,043
From 1 - 5 Years	82,001	41,958	—	123,959
From 5 - 10 Years	69,832	58,097	—	127,929
Over 10 Years	3,330	—	1,000	4,330
Maturities of Debt Securities, at Fair Value:				
Within One Year	43,113	—	—	43,113
From 1 - 5 Years	83,896	41,788	—	125,684
From 5 - 10 Years	71,967	57,127	—	129,094
Over 10 Years	3,414	—	1,000	4,414
Securities in a Continuous Loss Position, at Fair Value:				
Less than 12 Months	$23,633	$85,339	$—	$108,972
12 Months or Longer	5,111	—	—	5,111
Total	$28,744	$85,339	$—	$114,083
Number of Securities in a Continuous Loss Position	101	36	—	137
Unrealized Losses on Securities in a Continuous Loss Position:				
Less than 12 Months	$519	$1,164	$—	$1,683
12 Months or Longer	59	—	—	59
Total	$578	$1,164	$—	$1,742
December 31, 2012				
Held-To-Maturity Securities, at Amortized Cost	$183,373	$55,430	$1,000	$239,803
Held-To-Maturity Securities,	191,196	56,056	1,000	248,252

at Fair Value				
Gross Unrealized Gains	7,886	626	—	8,512
Gross Unrealized Losses	63	—	—	63
Held-To-Maturity Securities, Pledged as Collateral				238,803

68

Held-To-Maturity Securities

	State and Municipal Obligations	Mortgage-Backed Securities - Residential	Corporate and Other Debt Securities	Total Held-To Maturity Securities
Securities in a Continuous Loss Position, at Fair Value:				
Less than 12 Months	$21,583	$—	$—	$21,583
12 Months or Longer	503	—	—	503
Total	$22,086	$—	$—	$22,086
Number of Securities in a Continuous Loss Position	61	—	—	61
Unrealized Losses on Securities in a Continuous Loss Position:				
Less than 12 Months	$62	$—	$—	$62
12 Months or Longer	1	—	—	1
Total	$63	$—	$—	$63

In the tables above, maturities of mortgage-backed-securities - residential are included based on their expected average lives. Actual maturities will differ from the table below because issuers may have the right to call or prepay obligations with or without prepayment penalties.

In the available-for-sale category at December 31, 2013, U.S. agency obligations consisted solely of U.S. Government Agency securities with an amortized cost of $136.9 million and a fair value of $136.5 million. Mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of $31.5 million and a fair value of $32.2 million and GSE securities with an amortized cost of $139.8 million and a fair value of $143.6 million. In the held-to-maturity category at December 31, 2013, mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of $4.9 million and a fair value of $4.7 million and GSE securities with an amortized cost of $95.2 million and a fair value of $94.2 million.

In the available-for-sale category at December 31, 2012, U.S. agency obligations consisted solely of U.S. Government Agency securities with an amortized cost of $122.3 million and a fair value of $122.5 million. Mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of $36.4 million and a fair value of $37.8 million and GSE securities with an amortized cost of $216.1 million and a fair value of $224.0 million. In the held-to-maturity category at December 31, 2012, mortgage-backed securities-residential consisted of GSEs with an amortized cost of $55.4 million and a fair value of $56.1 million.

Securities in a continuous loss position, in the tables above for December 31, 2013 and December 31, 2012 do not reflect any deterioration of the credit worthiness of the issuing entities. U.S. agency issues, including mortgage-backed securities, are all rated Aaa by Moody's and AA+ by Standard and Poor's. The state and municipal obligations are general obligations supported by the general taxing authority of the issuer, and in some cases are insured. Obligations issued by school districts are supported by state aid. For any non-rated municipal securities, credit analysis is performed in-house based upon data that has been submitted by the issuers to the NY State Comptroller. That analysis shows no deterioration in the credit worthiness of the municipalities. Subsequent to December 31, 2013, there were no securities downgraded below investment grade.

The unrealized losses on these temporarily impaired securities are primarily the result of changes in interest rates for fixed rate securities where the interest rate received is less than the current rate available for new offerings of similar securities, changes in market spreads as a result of shifts in supply and demand, and/or changes in the level of prepayments for mortgage related securities. Because we do not currently intend to sell any of our temporarily impaired securities, and because it is not more likely-than-not we would be required to sell the securities prior to recovery, the impairment is considered temporary.

Schedule of Federal Reserve Bank and Federal Home Loan Bank Stock

Federal Reserve Bank and Federal Home Loan Bank Stock are carried at cost.

	December 31,	
	2013	2012
Federal Reserve Bank Stock	$1,035	$1,018
Federal Home Loan Bank Stock	5,246	4,774
Total Federal Reserve Bank and Federal Home Loan Bank Stock	$6,281	$5,792

69

Note 5: LOANS (Dollars In Thousands)

Loan Categories and Past Due Loans

The following table presents loan balances outstanding as of December 31, 2013 and December 31, 2012 and an analysis of the recorded investment in loans that are past due at these dates. Generally, Arrow considers a loan past due 30 or more days if the borrower is two or more payments past due.
Schedule of Past Due Loans by Loan Category

	Commercial	Commercial Construction	Commercial Real Estate	Other Consumer	Automobile	Residential	Total
December 31, 2013							
Loans Past Due 30-59 Days	$304	$—	$200	$37	$3,233	$529	$4,303
Loans Past Due 60-89 Days	601	—	1,200	19	1,041	1,527	4,388
Loans Past Due 90 or More Days	177	—	2,034	—	98	3,113	5,422
Total Loans Past Due	1,082	—	3,434	56	4,372	5,169	14,113
Current Loans	86,811	27,815	284,685	7,593	389,832	455,623	1,252,359
Total Loans	$87,893	$27,815	$288,119	$7,649	$394,204	$460,792	$1,266,472
Loans 90 or More Days Past Due and Still Accruing Interest	$28	$—	$—	$—	$—	$624	$652
Nonaccrual Loans	$352	$—	$2,048	$—	$219	$3,860	$6,479
December 31, 2012							
Loans Past Due 30-59 Days	$1,045	$—	$534	$43	$2,427	$407	$4,456
Loans Past Due 60-89 Days	1,588	—	1,332	17	793	2,466	6,196
Loans Past Due 90 or more Days	494	—	1,871	—	185	1,462	4,012
Total Loans Past Due	3,127	—	3,737	60	3,405	4,335	14,664
Current Loans	102,409	29,149	241,440	6,624	345,695	432,360	1,157,677
Total Loans	$105,536	$29,149	$245,177	$6,684	$349,100	$436,695	$1,172,341
Loans 90 or More Days Past Due and Still Accruing Interest	$126	$—	$378	$—	$42	$374	$920
Nonaccrual Loans	$1,787	$—	$2,026	$1	$419	$2,400	$6,633

The Company disaggregates its loan portfolio into the following six categories:

Commercial - The Company offers a variety of loan options to meet the specific needs of our commercial customers including term loans, time notes and lines of credit. Such loans are made available to businesses for working capital needs such as inventory and receivables, business expansion and equipment purchases. Generally, a collateral lien is placed on equipment or other assets owned by the borrower. These loans carry a higher risk than commercial real estate loans due to the nature of the underlying collateral, which can be business assets such as equipment and accounts receivable and generally have a lower liquidation value than real estate. In the event of default by the borrower, the Company may be required to liquidate collateral at deeply discounted values. To reduce the risk, management usually obtains personal guarantees of the borrowers.

Commercial Construction - The Company offers commercial construction and land development loans to finance projects within the communities that we serve. Many projects will ultimately be used by the borrowers' businesses, while others are developed for resale. These real estate loans are secured by first liens on the real estate, which may include apartments, commercial structures, housing businesses, healthcare facilities, and both owner-occupied and nonowner-occupied facilities. There is enhanced risk during the construction period, since the loan is secured by an incomplete project.

Commercial Real Estate - The Company offers commercial real estate loans to finance real estate purchases, refinancings, expansions and improvements to commercial properties. Commercial real estate loans are made to finance the purchases of real property which generally consists of real estate with completed structures. These commercial real estate loans are secured by

70

first liens on the real estate, which may include apartments, commercial structures, housing businesses, healthcare facilities, and both owner and non owner-occupied facilities. These loans are typically less risky than commercial loans, since they are secured by real estate and buildings, and are generally originated in amounts of no more than 80% of the appraised value of the property.

Other Consumer Loans - The Company offers a variety of consumer installment loans to finance personal expenditures. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from one to five years, based upon the nature of the collateral and the size of the loan. In addition to installment loans, the Company also offers personal lines of credit and overdraft protection. Several loans are unsecured, which carry a higher risk of loss.

Automobile - The Company primarily finances the purchases of automobiles indirectly through dealer relationships located throughout upstate New York and Vermont. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from three to seven years. The majority of indirect consumer loans are underwritten on a secured basis using the underlying collateral being financed.

Residential Real Estate Mortgages - Residential real estate loans consist primarily of loans secured by first or second mortgages on primary residences. We originate adjustable-rate and fixed-rate one-to-four-family residential real estate loans for the construction, purchase or refinancing of a mortgage. These loans are collateralized primarily by owner-occupied properties generally located in the Company’s market area. Loans on one-to-four-family residential real estate are generally originated in amounts of no more than 85% of the purchase price or appraised value (whichever is lower), or have private mortgage insurance. The Company’s underwriting analysis for residential mortgage loans typically includes credit verification, independent appraisals, and a review of the borrower’s financial condition. Mortgage title insurance and hazard insurance are normally required. Construction loans have a unique risk, because they are secured by an incomplete dwelling. This risk is reduced through periodic site inspections, including one at each loan draw period. In addition, the Company offers fixed home equity loans as well as home equity lines of credit to consumers to finance home improvements, debt consolidation, education and other uses. Our policy allows for a maximum loan to value ratio of 80%. The Company originates home equity lines of credit and second mortgage loans (loans secured by a second junior lien position on one-to-four-family residential real estate). Risk is generally reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower's financial condition and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate.

Allowance for Loan Losses

The following table presents a rollforward of the allowance for loan losses and other information pertaining to the allowance for loan losses:

Allowance for Loan Losses

	Commercial	Commercial Construction	Commercial Real Estate	Other Consumer	Automobile	Residential	Unallocated	Total
Rollfoward of the Allowance for Loan Losses for the Year Ended:								
December 31, 2012	$2,344	$601	$3,050	$304	$4,536	$3,405	$1,058	$15,298
Charge-offs	(926)	—	(11)	(28)	(431)	(15)	—	(1,411)

Recoveries	88	—	—	3	256	—	—	347
Provision	380	(184)	506	(7)	(155)	(364)	24	200
December 31, 2013	$1,886	$417	$3,545	$272	$4,206	$3,026	$1,082	$14,434
December 31, 2011	$1,927	$602	$3,136	$350	$4,496	$3,414	$1,078	$15,003
Charge-offs	(90)	—	(206)	(52)	(401)	(33)	—	(782)
Recoveries	23	—	—	9	200	—	—	232
Provision	484	(1)	120	(3)	241	24	(20)	845
December 31, 2012	$2,344	$601	$3,050	$304	$4,536	$3,405	$1,058	$15,298
December 31, 2010	$2,037	$135	$2,993	$328	$4,760	$3,163	$1,273	$14,689
Charge-offs	(105)	—	—	(42)	(480)	(147)	—	(774)
Recoveries	17	—	—	28	198	—	—	243
Provision	(22)	467	143	36	18	398	(195)	845
December 31, 2011	$1,927	$602	$3,136	$350	$4,496	$3,414	$1,078	$15,003

71

Allowance for Loan Losses

	Commercial	Commercial Construction	Commercial Real Estate	Other Consumer	Automobile	Residential	Unallocated	Total
December 31, 2013								
Allowance for loan losses - Loans Individually Evaluated for Impairment	$ —	$ —	$ —	$—	$—	$—	$ —	$—
Allowance for loan losses - Loans Collectively Evaluated for Impairment	$ 1,886	$ 417	$ 3,545	$272	$4,206	$3,026	$ 1,082	$ 14,434
Ending Loan Balance - Individually Evaluated for Impairment	$ 221	$ —	$ 1,785	$—	$173	$2,309	$ —	$4,488
Ending Loan Balance - Collectively Evaluated for Impairment	$ 87,672	$ 27,815	$ 286,334	$7,649	$394,031	$458,483	$ —	$ 1,261,984
December 31, 2012								
Allowance for loan losses - Loans Individually Evaluated for Impairment	$ 853	$ —	$ —	$—	$—	$—	$ —	$853
Allowance for loan losses - Loans Collectively Evaluated for Impairment	$ 1,491	$ 601	$ 3,050	$304	$4,536	$3,405	$ 1,058	$ 14,445
Ending Loan Balance - Individually Evaluated for Impairment	$ 1,432	$ —	$ 2,528	$—	$203	$1,090	$ —	$5,253
Ending Loan Balance -	$ 104,104	$ 29,149	$ 242,649	$6,684	$348,897	$435,605	$ —	$ 1,167,088

Collectively
Evaluated for
Impairment

Through the provision for loan losses, an allowance for loan losses is maintained that reflects our best estimate of the inherent risk of loss in the Company's loan portfolio as of the balance sheet date. Additions are made to the allowance for loan losses through a periodic provision for loan losses. Actual loan losses are charged against the allowance for loan losses when loans are deemed uncollectible and recoveries of amounts previously charged off are recorded as credits to the allowance for loan losses.

Our loan officers and risk managers meet at least quarterly to discuss and review the conditions and risks associated with certain criticized and classified commercial-related relationships. In addition, our independent internal loan review department performs periodic reviews of the credit quality indicators on individual loans in our commercial loan portfolio.

We use a two-step process to determine the provision for loan losses and the amount of the allowance for loan losses. We measure impairment on our impaired loans on a quarterly basis. Our impaired loans are generally nonaccrual loans over $250 thousand and all troubled debt restructured loans. Our impaired loans are generally considered to be collateral dependent with the specific reserve, if any, determined based on the value of the collateral less estimated costs to sell.

The remainder of the portfolio is evaluated on a pooled basis, as described below. For each homogeneous loan pool, we estimate a total loss factor based on the historical net loss rates adjusted for applicable qualitative factors. We update the total loss factors assigned to each loan category on a quarterly basis. For the commercial, commercial construction, and commercial real estate categories, we further segregate the loan categories by credit risk profile (pools of loans graded pass, special mention and accruing substandard). Additional description of the credit risk classifications is detailed in the Credit Quality Indicators section of this note.

We determine the historical net loss rate for each loan category using a trailing three-year net charge-off average. While historical net loss experience provides a reasonable starting point for our analysis, historical net losses, or even recent trends in net losses, do not by themselves form a sufficient basis to determine the appropriate level of the allowance for loan losses. Therefore, we also consider and adjust historical net loss factors for qualitative factors that impact the inherent risk of loss associated with our loan categories within our total loan portfolio. These include:

- Changes in the volume and severity of past due, nonaccrual and adversely classified loans
- Changes in the nature and volume of the portfolio and in the terms of loans
- Changes in the value of the underlying collateral for collateral dependent loans
- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses
- Changes in the quality of the loan review system
- Changes in the experience, ability, and depth of lending management and other relevant staff
- Changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations
- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing portfolio or pool

While not a significant part of the allowance for loan losses methodology, we also maintain an unallocated portion of the total allowance for loan losses related to the overall level of imprecision inherent in the estimation of the appropriate level of allowance for loan losses.

Loan Credit Quality Indicators

The following table presents the credit quality indicators by loan category at December 31, 2013 and December 31, 2012:

Loan Credit Quality Indicators

	Commercial	Commercial Construction	Commercial Real Estate	Other Consumer	Automobile	Residential	Total
December 31, 2013							
Credit Risk Profile by Creditworthiness Category:							
Satisfactory	$79,966	$27,815	$267,612				$375,393
Special Mention	204	—	634				838
Substandard	7,723	—	19,873				27,596
Doubtful	—	—	—				—
Credit Risk Profile Based on Payment Activity:							
Performing				$7,649	$393,985	$456,308	857,942
Nonperforming				—	219	4,484	4,703
December 31, 2012							
Credit Risk Profile by Creditworthiness Category:							
Satisfactory	$97,085	$27,913	$225,312				$350,310
Special Mention	192	—	1,419				1,611
Substandard	6,872	1,236	18,446				26,554
Doubtful	1,387	—	—				1,387
Credit Risk Profile Based on Payment Activity:							
Performing				$6,683	$348,676	$433,922	$789,281
Nonperforming				1	424	2,773	3,198

For the purposes of the table above, nonperforming automobile, residential and other consumer loans are those loans on nonaccrual status or are 90 days or more past due and still accruing interest.

For the allowance calculation, we use an internally developed system of five credit quality indicators to rate the credit worthiness of each commercial loan defined as follows:

1) Satisfactory - "Satisfactory" borrowers have acceptable financial condition with satisfactory record of earnings and sufficient historical and projected cash flow to service the debt. Borrowers have satisfactory repayment histories and primary and secondary sources of repayment can be clearly identified;

2) Special Mention - Loans in this category have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. "Special mention" assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Loans which might be assigned this credit quality indicator include loans to borrowers with deteriorating financial strength and/or earnings record and loans with potential for problems due to weakening economic or market conditions;

3) Substandard - Loans classified as "substandard" are inadequately protected by the current sound net worth or paying capacity of the borrower or the collateral pledged, if any. Loans in this category have well defined weaknesses that jeopardize the repayment. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. "Substandard" loans may include loans which are likely to require liquidation of collateral to effect repayment, and other loans where character or ability to repay has become suspect. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard;

4) Doubtful - Loans classified as "doubtful" have all of the weaknesses inherent in those classified as "substandard" with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current existing facts, conditions, and values highly questionable and improbable. Although possibility of loss is extremely high, classification of these loans as "loss" has been deferred due to specific pending factors or events which may strengthen the value (i.e. possibility of additional collateral, injection of capital, collateral liquidation, debt restructure, economic recovery, etc). Loans classified as "doubtful" need to be placed on non-accrual; and

5) Loss - Loans classified as "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. As of the date of the balance sheet, all loans in this category have been charged-off to the allowance for loan losses.

Commercial loans are generally evaluated on an annual basis depending on the size and complexity of the loan relationship, unless the credit related quality indicator falls to a level of "special mention" or below, when the loan is evaluated quarterly. The credit quality indicator is one of the factors used in assessing the level of inherent risk of loss in our commercial related loan portfolios.

Impaired Loans

The following table presents information on impaired loans based on whether the impaired loan has a recorded allowance or no recorded allowance:

Impaired Loans

	Commercial	Commercial Construction	Commercial Real Estate	Other Consumer	Automobile	Residential	Total
December 31, 2013							
Recorded Investment:							
With No Related Allowance	$221	$—	$1,785	$—	$173	$2,309	$4,488
With a Related Allowance	—	—	—	—	—	—	—
Unpaid Principal Balance:							
With No Related Allowance	$221	$—	$1,785	$—	$173	$2,309	$4,488
With a Related Allowance	—	—	—	—	—	—	—
December 31, 2012							
Recorded Investment:							
With No Related Allowance	$45	$—	$2,528	$—	$203	$1,090	$3,866
With a Related Allowance	1,387	—	—	—	—	—	$1,387
Unpaid Principal Balance:							
With No Related Allowance	$45	$—	$2,695	$—	$203	$1,090	$4,033
With a Related Allowance	1,387	—	—	—	—	—	$1,387
For the Year-To-Date Period Ended:							
December 31, 2013							
Average Recorded Balance:							
With No Related Allowance	$133	$—	$2,157	$—	$188	$1,700	$4,178
With a Related Allowance	694	—	—	—	—	—	694
Interest Income Recognized:							
With No Related Allowance	$4	$—	$—	$—	$9	$8	$21
With a Related Allowance	—	—	—	—	—	—	—
Cash Basis Income:							
With No Related Allowance	$—	$—	$—	$—	$—	$—	$—
With a Related Allowance	—	—	—	—	—	—	—
December 31, 2012							
Average Recorded Balance:							
With No Related Allowance	$56	$—	$2,241	$—	$236	$1,599	$4,132
With a Related Allowance	694	—	—	—	—	—	$694
Interest Income Recognized:							
With No Related Allowance	$6	$—	$64	$—	$12	$9	$91
With a Related Allowance	—	—	—	—	—	—	$—
Cash Basis Income:							
With No Related Allowance	$—	$—	$64	$—	$—	$—	$64
With a Related Allowance	—	—	—	—	—	—	$—

December 31, 2011							
Average Recorded Balance:							
With No Related Allowance	$40	$—	$1,993	$5	$274	$1,328	$3,640
Interest Income Recognized:							
With No Related Allowance	$6	$—	$42	$—	$19	$7	$74
Cash Basis Income:							
With No Related Allowance	$—	$—	$42	$—	$—	$—	$42

At December 31, 2013 and December 31, 2012, all impaired loans were considered to be collateral dependent and were therefore evaluated for impairment based on the fair value of collateral less estimated cost to sell. There was no allowance for loan losses allocated to impaired loans at December 31, 2013. Interest income recognized in the table above, represents income earned after the loans became impaired and includes restructured loans in compliance with their modified terms and nonaccrual loans where we have recognized interest income on a cash basis.

Loans Modified in Trouble Debt Restructurings

The following table presents information on loans modified in trouble debt restructurings during the periods indicated:
Loans Modified in Trouble Debt Restructurings During the Period

	Commercial	Commercial Construction	Commercial Real Estate	Other Consumer	Automobile	Residential	Total
For the Year Ended:							
December 31, 2013							
Number of Loans	1	—	—	—	9	—	10
Pre-Modification Outstanding Recorded Investment	$169	$—	$—	$—	$88	$—	$257
Post-Modification Outstanding Recorded Investment	$200	$—	$—	$—	$88	$—	$288
Subsequent Default, Number of Contracts	—	—	—	—	—	—	—
Subsequent Default, Recorded Investment	—	—	—	—	—	—	—
Commitments to lend additional funds to modified loans	—	—	—	—	—	—	—
December 31, 2012							
Number of Loans	—	—	2	—	17	—	19
Pre-Modification Outstanding Recorded Investment	$—	$—	$47	$—	$160	$—	$207
Post-Modification Outstanding Recorded Investment	$—	$—	$47	$—	$160	$—	$207
Subsequent Default, Number of Contracts	—	—	—	—	—	—	—
Subsequent Default, Recorded Investment	—	—	—	—	—	—	—
Commitments to lend additional funds to modified loans	—	—	—	—	—	—	—
December 31, 2011							
Number of Loans	1	—	1	—	14	1	17
Pre-Modification Outstanding Recorded Investment	$63	$—	$917	$—	$121	$242	$1,343
Post-Modification Outstanding Recorded Investment	$63	$—	$917	$—	$121	$242	$1,343
Subsequent Default, Number of Contracts	—	—	—	—	—	—	—

Subsequent Default, Recorded Investment	—	—	—	—	—	—	—
Commitments to lend additional funds to modified loans	—	—	—	—	—	—	—

In general, loans requiring modification are restructured to accommodate the projected cash-flows of the borrower. Such modifications may involve a reduction of the interest rate, a significant deferral of payments or forgiveness of a portion of the outstanding principal balance. As indicated in the table above, no loans modified during the preceding twelve months subsequently defaulted as of December 31, 2013 or December 31, 2012.

76

Schedule of Supplemental Loan Information

	2013	2012
Supplemental Information:		
Unamortized deferred loan origination costs, net of deferred loan origination fees, included in the above balances	$2,152	$1,571
Overdrawn deposit accounts, included in the above balances	501	690
Pledged loans secured by one-to-four family residential mortgages under a blanket collateral agreement to secure borrowings from the Federal Home Loan Bank of New York	270,372	133,709
Residential real estate loans serviced for Freddie Mac, not included in the balances above	156,593	134,688
Loans held for sale at period-end, included in the above balances	64	2,801
Loans to Related Parties:		
Balance at beginning of year	$17,447	$15,772
Adjustment due to change in composition of related parties	(8,819)	45
New loans and renewals, during the year	2,253	5,939
Repayments, during the year	(3,112)	(4,309)
Balance at end of year	$7,769	$17,447

Note 6: PREMISES AND EQUIPMENT (In Thousands)

A summary of premises and equipment at December 31, 2013 and 2012 is presented below:

	2013	2012
Land and Bank Premises	$35,114	$33,908
Equipment, Furniture and Fixtures	20,851	20,123
Leasehold Improvements	1,190	957
Total Cost	57,155	54,988
Accumulated Depreciation and Amortization	(28,001)	(26,091)
Net Premises and Equipment	$29,154	$28,897

Amounts charged to expense for depreciation totaled $1,928, $1,521 and $1,382 in 2013, 2012 and 2011, respectively.

77

Note 7: OTHER INTANGIBLE ASSETS (In Thousands)

The following table presents information on Arrow’s intangible assets (other than goodwill) as of December 31, 2013, 2012 and 2011:

	Depositor Intangibles[1]	Mortgage Servicing Rights[2]	Customer Intangibles[1]	Total
Gross Carrying Amount, December 31, 2013	$2,247	$1,582	$4,451	$8,280
Accumulated Amortization	(2,186)	(622)	(1,332)	(4,140)
Net Carrying Amount, December 31, 2013	$61	$960	$3,119	$4,140
Gross Carrying Amount, December 31, 2012	$2,247	$1,251	$4,451	$7,949
Accumulated Amortization	(2,094)	(392)	(971)	(3,457)
Net Carrying Amount, December 31, 2012	$153	$859	$3,480	$4,492
Rollforward of Intangible Assets:				
Balance, December 31, 2010	$460	$371	$627	$1,458
Intangible Assets Acquired	—	339	3,573	3,912
Amortization of Intangible Assets	(174)	(111)	(336)	(621)
Balance, December 31, 2011	286	599	3,864	4,749
Intangible Assets Acquired	—	417	—	417
Amortization of Intangible Assets	(133)	(157)	(384)	(674)
Balance, December 31, 2012	153	859	3,480	4,492
Intangible Assets Acquired	—	331	—	331
Amortization of Intangible Assets	(92)	(230)	(361)	(683)
Balance, December 31, 2013	$61	$960	$3,119	$4,140

[1] Amortization of depositor intangibles and customer intangibles are reported in the consolidated statements of income as a component of other operating expense.
[2] Amortization of mortgage servicing rights is reported in the consolidated statements of income as a reduction of mortgage servicing fee income, which is included with fees for other services to customers.

The following table presents the remaining estimated annual amortization expense for Arrow's intangible assets as of December 31, 2013:

	Depositor Intangibles[1]	Mortgage Servicing Rights[2]	Customer Intangibles[1]	Total
Estimated Annual Amortization Expense:				
2014	$51	$253	$337	$641
2015	10	230	319	559
2016	—	209	301	510
2017	—	150	281	431
2018	—	96	263	359
Later Years	—	22	1,618	1,640
Total	$61	$960	$3,119	$4,140

[1] Amortization of depositor intangibles and customer intangibles are reported in the consolidated statements of income as a component of other operating expense.

[2] Amortization of mortgage servicing rights is reported in the consolidated statements of income as a reduction of mortgage servicing fee income, which is included with fees for other services to customers.

78

Note 8: GUARANTEES (Dollars In Thousands)

The following table presents the notional amount and fair value of Arrow's off-balance sheet commitments to extend credit and commitments under standby letters of credit as of December 31, 2013 and 2012:

Balance at December 31,	2013	2012
Notional Amount:		
Commitments to Extend Credit	$237,940	$198,405
Standby Letters of Credit	3,345	10,929
Fair Value:		
Commitments to Extend Credit	$—	$—
Standby Letters of Credit	65	120

Arrow is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit include home equity lines of credit, commitments for residential and commercial construction loans and other personal and commercial lines of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of the involvement Arrow has in particular classes of financial instruments.

Arrow's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Arrow uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Arrow evaluates each customer's creditworthiness on a case-by-case basis. Home equity lines of credit are secured by residential real estate. Construction lines of credit are secured by underlying real estate. For other lines of credit, the amount of collateral obtained, if deemed necessary by Arrow upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties. Most of the commitments are variable rate instruments.

Arrow does not issue any guarantees that would require liability-recognition or disclosure, other than its standby letters of credit.

Arrow has issued conditional commitments in the form of standby letters of credit to guarantee payment on behalf of a customer and guarantee the performance of a customer to a third party. Standby letters of credit generally arise in connection with lending relationships. The credit risk involved in issuing these instruments is essentially the same as that involved in extending loans to customers. Contingent obligations under standby letters of credit at December 31, 2013 and 2012 represent the maximum potential future payments Arrow could be required to make. Typically, these instruments have terms of 12 months or less and expire unused; therefore, the total amounts do not necessarily represent future cash requirements. Each customer is evaluated individually for creditworthiness under the same underwriting standards used for commitments to extend credit and on-balance sheet instruments. Company policies governing loan collateral apply to standby letters of credit at the time of credit extension. Loan-to-value ratios will generally range from 50% for movable assets, such as inventory, to 100% for liquid assets, such as bank CD's. Fees for standby letters of credit range from 1% to 3% of the notional amount. Fees are collected upfront and amortized over the life of the commitment. The carrying amount and fair value of Arrow's standby letters of credit at December 31, 2013 and 2012 were insignificant. The fair value of standby letters of credit is based on the fees currently charged for similar agreements or the cost to terminate the arrangement with the counterparties.

The fair value of commitments to extend credit is determined by estimating the fees to enter into similar agreements, taking into account the remaining terms and present creditworthiness of the counterparties, and for fixed rate loan commitments, the difference between the current and committed interest rates. Arrow provides several types of commercial lines of credit and standby letters of credit to its commercial customers. The pricing of these services is not isolated as Arrow considers the customer's complete deposit and borrowing relationship in pricing individual products and services. The commitments to extend credit also include commitments under home equity lines of credit, for which Arrow charges no fee. The carrying value and fair value of commitments to extend credit are not material and Arrow does not expect to incur any material loss as a result of these commitments.

In the normal course of business, Arrow and its subsidiary banks become involved in a variety of routine legal proceedings. At present, there are no legal proceedings pending or threatened, which in the opinion of management and counsel, would result in a material loss to Arrow.

Note 9: TIME DEPOSITS (Dollars In Thousands)

The following summarizes the contractual maturities of time deposits during years subsequent to December 31, 2013:

Year of Maturity	Total Time Deposits
2014	$163,032
2015	31,277
2016	17,450
2017	18,418
2018	13,076
2019 and Beyond	3,974
Total	$247,227

Note 10: DEBT (Dollars in Thousands)

Schedule of Short-Term Borrowings:

	2013	2012
Balances at December 31:		
Overnight Advances from the Federal Home Loan Bank of New York	$53,000	$29,000
Securities Sold Under Agreements to Repurchase	11,777	12,678
Total Short-Term Borrowings	$64,777	$41,678
Maximum Borrowing Capacity at December 31:		
Federal Funds Purchased	$30,000	$30,000
Overnight Advances from the Federal Home Loan Bank of New York	214,000	90,000
Federal Reserve Bank of New York	302,000	268,000

Securities sold under agreements to repurchase mature in one day. Arrow maintains effective control over the securities underlying the agreements.

Arrow's subsidiary banks have in place unsecured federal funds lines of credit with three correspondent banks. As a member of the FHLBNY, we participate in the advance program which allows for overnight and term advances up to the limit of pledged collateral, including FHLBNY stock, mortgage-backed securities and residential real estate loans (see Note 4. "Investment Securities" and Note 5. "Loans"). Our investment in FHLBNY stock is proportional to the total of our overnight and term advances (see the Schedule of Federal Reserve Bank and Federal Home Loan Bank Stock in Note 4. "Investment Securities"). Our bank subsidiaries have also established borrowing facilities with the Federal Reserve Bank of New York for potential “discount window” advances, pledging certain consumer loans as collateral (see Note 5. "Loans").

Long Term Debt - FHLBNY Term Advances

In addition to overnight advances, Arrow also borrows longer-term funds from the FHLBNY. Certain borrowings are in the form of “convertible advances.” These advances have a set final maturity, but are callable by the FHLBNY at certain dates beginning no earlier than one year from the issuance date. If the advances are called, Arrow may elect to have the funds replaced by the FHLBNY at the then prevailing market rate of interest.

Maturity Schedule of FHBLNY Term Advances:

	Balances		Weighted Average Rate			
Final Maturity	2013	2012	2013		2012	
First Year	$10,000	$10,000	1.43	%	1.65	%
Second Year	10,000	10,000	3.88	%	1.43	%
Third Year	—	10,000	—	%	3.88	%
Total	$20,000	$30,000	2.66	%	2.32	%

80

Long Term Debt - Guaranteed Preferred Beneficial Interests in Corporation's Junior Subordinated Debentures

During 2013, there were outstanding two classes of financial instruments issued by two separate subsidiary business trusts of Arrow, identified as “Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts” on the Consolidated Balance Sheets and the Consolidated Statements of Income.

The first of the two classes of trust-issued instruments outstanding at year-end was issued by Arrow Capital Statutory Trust II ("ACST II"), a Delaware business trust established on July 16, 2003, upon the filing of a certificate of trust with the Delaware Secretary of State. In July 2003, ACST II issued all of its voting (common) stock to Arrow and issued and sold to an unaffiliated purchaser 30-year guaranteed preferred beneficial interests in the trust's assets ("ACST II trust preferred securities"). The rate on the securities is variable, adjusting quarterly to the 3-month LIBOR plus 3.15%. ACST II used the proceeds of the sale of its trust preferred securities to purchase an identical amount of junior subordinated debentures issued by Arrow that bear an interest rate identical at all times to the rate payable on the ACST II trust preferred securities. The ACST II trust preferred securities became redeemable after July 23, 2008 and mature on July 23, 2033.

The second of the two classes of trust-issued instruments outstanding at year-end was issued by Arrow Capital Statutory Trust III ("ACST III"), a Delaware business trust established on December 23, 2004, upon the filing of a certificate of trust with the Delaware Secretary of State. On December 28, 2004, the ACST III issued all of its voting (common) stock to Arrow and issued and sold to an unaffiliated purchaser 30-year guaranteed preferred beneficial interests in the trust's assets ("ACST III"). The rate on the ACST III trust preferred securities is a variable rate, adjusted quarterly, equal to the 3-month LIBOR plus 2.00%. ACST III used the proceeds of the sale of its trust preferred securities to purchase an identical amount of junior subordinated debentures issued by Arrow that bear an interest rate identical at all times to the rate payable on the ACST III trust preferred securities. The ACST III trust preferred securities became redeemable on or after March 31, 2010 and mature on December 28, 2034.

The primary assets of the two subsidiary trusts having trust preferred securities outstanding at year-end, ACST II and ACST III (the “Trusts”), are Arrow's junior subordinated debentures discussed above, and the sole revenues of the Trusts are payments received by them from Arrow with respect to the junior subordinated debentures. The trust preferred securities issued by the Trusts are non-voting. All common voting securities of the Trusts are owned by Arrow. Arrow used the net proceeds from its sale of junior subordinated debentures to the Trusts, facilitated by the Trust’s sale of their trust preferred securities to the purchasers thereof, for general corporate purposes. The trust preferred securities and underlying junior subordinated debentures, with associated expense that is tax deductible, qualify as Tier I capital under regulatory definitions.

Arrow's primary source of funds to pay interest on the debentures that are held by the Trusts are current dividends received by Arrow from its subsidiary banks. Accordingly, Arrow's ability to make payments on the debentures, and the ability of the Trusts to make payments on their trust preferred securities, are dependent upon the continuing ability of Arrow's subsidiary banks to pay dividends to Arrow. Since the trust preferred securities issued by the subsidiary trusts and the underlying junior subordinated debentures issued by Arrow at December 31, 2013, 2012 and 2011 are classified as debt for financial statement purposes, the expense associated with these securities is recorded as interest expense in the consolidated statements of income for the three years.

Schedule of Guaranteed Preferred Beneficial Interests in Corporation's Junior Subordinated Debentures

	2013		2012	
ACST II				
Balance at December 31,	$10,000		$10,000	
Period-End Interest Rate	3.40	%	3.51	%
ACST III				
Balance at December 31,	$10,000		$10,000	
Period-End Interest Rate	2.25	%	2.36	%

81

Note 11: COMPREHENSIVE INCOME (Dollars In Thousands)

The following table presents the components of other comprehensive income for the years ended December 31, 2013, 2012 and 2011:
Schedule of Comprehensive Income

	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
2013			
Net Unrealized Securities Holding Gains Arising During the Period	$(4,843)	$1,918	$(2,925)
Reclassification Adjustment for Securities Gains Included in Net Income	(540)	214	(326)
Net Retirement Plan Loss	10,640	(4,215)	6,425
Amortization of Net Retirement Plan Actuarial Loss	1,513	(599)	914
Accretion of Net Retirement Plan Prior Service Credit	2	(1)	1
Other Comprehensive Income	$6,772	$(2,683)	$4,089
2012			
Net Unrealized Securities Holding Gains Arising During the Period	$(1,094)	$433	$(661)
Reclassification Adjustment for Securities Gains Included in Net Income	(865)	343	(522)
Net Retirement Plan Loss	(2,218)	878	(1,340)
Net Retirement Plan Prior Service Credit	(405)	160	(245)
Amortization of Net Retirement Plan Actuarial Loss	1,677	(664)	1,013
Accretion of Net Retirement Plan Prior Service Credit	(20)	8	(12)
Other Comprehensive Income	$(2,925)	$1,158	$(1,767)
2011			
Net Unrealized Securities Holding Gains Arising During the Period	$7,850	$(3,109)	$4,741
Reclassification Adjustment for Securities Gains Included in Net Income	(2,795)	1,107	(1,688)
Net Retirement Plan Loss	(6,129)	2,428	(3,701)
Net Retirement Plan Prior Service Credit	(266)	105	(161)
Amortization of Net Retirement Plan Actuarial Loss	996	(394)	602
Accretion of Net Retirement Plan Prior Service Credit	(108)	43	(65)
Other Comprehensive Income	$(452)	$180	$(272)

82

The following table presents the changes in accumulated other comprehensive income by component:

Changes in Accumulated Other Comprehensive Income (Loss) by Component [1]

	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Plan Items		
		Net Gain (Loss)	Net Prior Service (Cost) Credit	Total
For the Year-To-Date periods ended:				
December 31, 2012	$5,625	$(14,036)	$(51)	$(8,462)
Other comprehensive income (loss) before reclassifications	(2,925)	6,425	—	3,500
Amounts reclassified from accumulated other comprehensive income (loss)	(326)	914	1	589
Net current-period other comprehensive income	(3,251)	7,339	1	4,089
December 31, 2013	$2,374	$(6,697)	$(50)	$(4,373)
December 31, 2011	$6,808	$(13,709)	$206	$(6,695)
Other comprehensive income (loss) before reclassifications	(661)	(1,340)	(245)	(2,246)
Amounts reclassified from accumulated other comprehensive income (loss)	(522)	1,013	(12)	479
Net current-period other comprehensive income	(1,183)	(327)	(257)	(1,767)
December 31, 2012	$5,625	$(14,036)	$(51)	$(8,462)
December 31, 2010	$3,755	$(10,610)	$432	$(6,423)
Other comprehensive income (loss) before reclassifications	4,741	(3,701)	(161)	879
Amounts reclassified from accumulated other comprehensive income (loss)	(1,688)	602	(65)	(1,151)
Net current-period other comprehensive income	3,053	(3,099)	(226)	(272)
December 31, 2011	$6,808	$(13,709)	$206	$(6,695)

(1) All amounts are net of tax. Amounts in parentheses indicate debits.

83

The following table presents the reclassifications out of accumulated other comprehensive income:
Reclassifications Out of Accumulated Other Comprehensive Income [1]

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income		Affected Line Item in the Statement Where Net Income Is Presented
For the Year-to-date periods ended:			
December 31, 2013			
Unrealized gains and losses on available-for-sale securities			
	$540		Gain on Securities Transactions, Net
	540		Total before tax
	(214	)	Provision for Income Taxes
	$326		Net of tax
Amortization of defined benefit pension items			
Prior-service costs	$(2	) [2]	Salaries and Employee Benefits
Actuarial gains/(losses)	(1,513	) [2]	Salaries and Employee Benefits
	(1,515	)	Total before tax
	600		Provision for Income Taxes
	$(915	)	Net of tax
Total reclassifications for the period	$(589	)	Net of tax
December 31, 2012			
Unrealized gains and losses on available-for-sale securities			
	$865		Gain on Securities Transactions, Net
	865		Total before tax
	(343	)	Provision for Income Taxes
	$522		Net of tax
Amortization of defined benefit pension items			
Prior-service costs	20	[2]	Salaries and Employee Benefits
Actuarial gains/(losses)	$(1,677	) [2]	Salaries and Employee Benefits
	(1,657	)	Total before tax
	656		Provision for Income Taxes
	$(1,001	)	Net of tax
Total reclassifications for the period	$(479	)	Net of tax

84

Reclassifications Out of Accumulated Other Comprehensive Income [1]

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income		Affected Line Item in the Statement Where Net Income Is Presented
December 31, 2011			
Unrealized gains and losses on available-for-sale securities			
	$2,795		Gain on Securities Transactions, Net
	2,795		Total before tax
	(1,107	)	Provision for Income Taxes
	$1,688		Net of tax
Amortization of defined benefit pension items			
Prior-service costs	108	[2]	Salaries and Employee Benefits
Actuarial gains/(losses)	$(996	) [2]	Salaries and Employee Benefits
	(888	)	Total before tax
	351		Provision for Income Taxes
	$(537	)	Net of tax
Total reclassifications for the period	$1,151		Net of tax

(1) Amounts in parentheses indicate debits to profit/loss.
(2) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see pension footnote for additional details).

85

Note 12: STOCK BASED COMPENSATION (Dollars In Thousands, Except Share and Per Share Amounts)

Arrow has established two stock based compensation plans: an Incentive and Non-qualified Stock Option Plan (Stock Option Plan) and an Employee Stock Ownership Plan (ESOP). All share and per share data have been adjusted for the September 2013 2% stock dividend.

Stock Option Plan

Options may be granted at a price no less than the greater of the par value or fair market value of such shares on the date on which such option is granted, and generally expire ten years from the date of grant. The options usually vest over a four-year period.

Roll Forward Schedule of Stock Option Plan by Shares and Weighted Average Exercise Prices

	Stock Option Plans	
Roll Forward of Shares Outstanding:		
Outstanding at January 1, 2013	451,210	
Granted	10,200	
Exercised	(59,612	)
Forfeited	(12,406	)
Outstanding at December 31, 2013	389,392	
Exercisable at December 31, 2013	269,758	
Vested and Expected to Vest	119,634	
Roll Forward of Shares Outstanding - Weighted Average Exercise Price:		
Outstanding at January 1, 2013	$22.67	
Granted	23.80	
Exercised	21.02	
Forfeited	24.71	
Outstanding at December 31, 2013	22.89	
Exercisable at December 31, 2013	22.29	
Vested and Expected to Vest	24.25	
Weighted Average Remaining Contractual Life (in years):		
Outstanding at December 31, 2013	5.57	
Exercisable at December 31, 2013	4.68	
Vested and Expected to Vest	7.58	
Aggregate Intrinsic Value:		
Outstanding at December 31, 2013	$1,429	
Exercisable at December 31, 2013	1,152	
Vested and Expected to Vest	277	
Shares Available for Grant at Period-End	459,000	

86

Schedule of Shares Authorized Under the Stock Option Plan by Exercise Price Range

	Exercise Price Ranges					
	$19.08 to $19.87	$21.24 to $22.27	$23.76 to $23.80	$24.43	$25.77	Total
Outstanding Options at December 31, 2013						
Number of Shares Outstanding	85,278	98,376	83,015	75,512	47,211	389,392
Weighted-Average Remaining Contractual Life (in years)	4.73	5.11	7.34	8.05	0.97	5.57
Weighted-Average Exercise Price	$19.64	$21.95	$23.77	$24.43	$25.77	$22.89
Exercisable Options at December 31, 2013						
Number of Shares Outstanding	85,278	81,150	36,391	19,728	47,211	269,758
Weighted-Average Remaining Contractual Life (in years)	4.73	4.90	7.09	7.94	0.97	4.68
Weighted-Average Exercise Price	$19.64	$21.88	$23.77	$24.42	$25.77	$22.29

Schedule of Other Stock Option Plan Information

	2013		2012		2011	
Shares Granted	10,200		77,302		79,994	
Weighted Average Grant Date Information:						
Fair Value of Options Granted	$5.46		$5.89		$6.00	
Fair Value Assumptions:						
Dividend Yield	4.20	%	3.93	%	4.00	%
Expected Volatility	36.57	%	37.43	%	36.50	%
Risk Free Interest Rate	1.31	%	1.22	%	2.54	%
Expected Lives (in years)	6.71		6.46		6.40	
Amount Expensed During the Year	$372		$424		$354	
Compensation Costs for Non-vested Awards Not Yet Recognized	420		737		705	
Weighted Average Expected Vesting Period, In Years	1.45		1.71		1.80	
Proceeds From Stock Options Exercised	$1,254		$2,105		$1,413	
Tax Benefits Related to Stock Options Exercised	23		68		51	
Intrinsic Value of Stock Options Exercised	267		2,434		1,740	

Employee Stock Ownership Plan

Arrow maintains an employee stock ownership plan ("ESOP"). Substantially all employees of Arrow and its subsidiaries are eligible to participate upon satisfaction of applicable service requirements. The ESOP borrowed funds from one of Arrow's subsidiary banks to purchase outstanding shares of Arrow's common stock. The notes require annual payments of principal and interest through 2018. As the debt is repaid, shares are released from collateral based on the proportion of debt paid to total debt outstanding for the year and allocated to active employees. In addition, the Company makes additional cash contributions to the Plan each year.

Schedule of ESOP Compensation Expense

	2013	2012	2011
ESOP Compensation Expense	$600	$550	$550

As the debt is repaid, shares are released from collateral based on the proportion of debt paid to total debt outstanding for the year and allocated to active employees.
Shares pledged as collateral are reported as unallocated ESOP shares in stockholders' equity. As shares are released from collateral, Arrow reports compensation expense equal to the current average market price of the shares, and the shares become outstanding for earnings per share computations. The ESOP shares as of December 31, 2013 were as follows:

87

Schedule of Shares in ESOP Plan

ESOP Plan Shares:	2013
Allocated Shares	644,248
Shares Released for Allocation During 2013	16,969
Unallocated Shares	87,641
Total ESOP Shares	748,858
Market Value of Unallocated Shares	$2,328

Note 13: RETIREMENT BENEFIT PLANS (Dollars in Thousands)

Arrow sponsors qualified and nonqualified defined benefit pension plans and other postretirement benefit plans for its employees. Arrow maintains a non-contributory pension plan, which covers substantially all employees. Effective December 1, 2002, all active participants in the qualified defined benefit pension plan were given a one-time irrevocable election to continue participating in the traditional plan design, for which benefits were based on years of service and the participant's final compensation (as defined), or to begin participating in the new cash balance plan design. All employees who participate in the plan after December 1, 2002 automatically participate in the cash balance plan design. The interest credits under the cash balance plan are based on the 30-year U.S. Treasury rate in effect for November of the prior year. The service credits under the cash balance plan are equal to 6.0% of eligible salaries for employees who become participants on or after January 1, 2003. For employees in the plan prior to January 1, 2003, the service credits are scaled based on the age of the participant, and range from 6.0% to 12.0%. The funding policy is to contribute up to the maximum amount that can be deducted for federal income tax purposes and to make all payments required under ERISA. Arrow also maintains a supplemental non-qualified unfunded retirement plan to provide eligible employees of Arrow and its subsidiaries with benefits in excess of qualified plan limits imposed by federal tax law.

Arrow has multiple non-pension postretirement benefit plans. The health care, dental and life insurance plans are contributory, with participants' contributions adjusted annually. Arrow's policy is to fund the cost of postretirement benefits based on the current cost of the underlying policies. However, the health care plan provision for automatic increases of Company contributions each year is based on the increase in inflation and is limited to a maximum of 5%.

The following tables set forth changes in the plans' benefit obligations (projected benefit obligation for pension benefits and accumulated benefit obligation for postretirement benefits) and changes in the plans' assets and the funded status of the pension plans and other postretirement benefit plan at December 31:

Schedule of Defined Benefit Plan Disclosures

	Employees' Pension Plan	Select Executive Retirement Plan	Postretirement Benefit Plans
Defined Benefit Plan Funded Status			
December 31, 2013			
Fair Value of Plan Assets	$44,653	$—	$—
Benefit Obligation	33,259	4,459	7,619
Funded Status of Plan	$11,394	$(4,459)	$(7,619)
December 31, 2012			
Fair Value of Plan Assets	$39,880	$—	$—
Benefit Obligation	37,046	5,324	9,213

Funded Status of Plan	$2,834	$(5,324)	$(9,213)
Change in Benefit Obligation			
Benefit Obligation, at January 1, 2013	$37,046	$5,324	$9,213
Service Cost	1,506	—	211
Interest Cost	1,261	163	308
Plan Participants' Contributions	—	—	368
Amendments	—	—	—
Actuarial Gain	(3,820)	(555)	(1,648)
Benefits Paid	(2,734)	(473)	(833)
Benefit Obligation, at December 31, 2013	$33,259	$4,459	$7,619

88

Schedule of Defined Benefit Plan Disclosures

	Employees' Pension Plan	Select Executive Retirement Plan	Postretirement Benefit Plans
Benefit Obligation, at January 1, 2012	$35,047	$4,529	$8,556
Service Cost	1,467	87	202
Interest Cost	1,436	190	338
Plan Participants' Contributions	—	—	348
Amendments	—	405	—
Actuarial Loss	2,857	441	491
Benefits Paid	(3,761)	(328)	(722)
Benefit Obligation, at December 31, 2012	$37,046	$5,324	$9,213
Change in Fair Value of Plan Assets			
Fair Value of Plan Assets, at January 1, 2013	$39,880	$—	$—
Actual Return on Plan Assets	7,507	—	—
Employer Contributions	—	473	465
Plan Participants' Contributions	—	—	368
Benefits Paid	(2,734)	(473)	(833)
Fair Value of Plan Assets, at December 31, 2013	$44,653	$—	$—
Change in Fair Value of Plan Assets, continued			
Fair Value of Plan Assets, at January 1, 2012	$39,206	$—	$—
Actual Return on Plan Assets	4,435	—	—
Employer Contributions	—	328	374
Plan Participants' Contributions	—	—	348
Benefits Paid	(3,761)	(328)	(722)
Fair Value of Plan Assets, at December 31, 2012	$39,880	$—	$—
Accumulated Benefit Obligation at December 31, 2013	$32,886	$4,459	$7,619
Amounts Recognized in the Consolidated Balance Sheets			
December 31, 2013			
Prepaid Pension Asset	$11,394	$—	—
Accrued Benefit Liability	—	(4,459)	(7,619)
Net Benefit Recognized	$11,394	$(4,459)	$(7,619)
December 31, 2012			
Prepaid Pension Asset	$2,834	$—	—
Accrued Benefit Liability	—	(5,324)	(9,213)
Net Benefit Recognized	$2,834	$(5,324)	$(9,213)
Amounts Recognized in Other Comprehensive Income (Loss)			
For the Year Ended December 31, 2013			
Net Unamortized Gain Arising During the Period	$(8,438)	$(554)	$(1,648)
Net Prior Service Cost Arising During the Period	—	—	—
Amortization of Net Loss	(1,231)	(140)	(142)
Amortization of Prior Service (Cost) Credit	(37)	(79)	114

Total Other Comprehensive (Loss) Income for Pension and Other Postretirement Benefit Plans	$(9,706)	$(773)	$(1,676)
For the Year Ended December 31, 2012			
Net Unamortized Loss Arising During the Period	$1,286	$441	$491
Net Prior Service Cost Arising During the Period	—	405	—
Amortization of Net Loss	(1,387)	(156)	(134)
Amortization of Prior Service (Cost) Credit	(41)	(53)	114
Total Other Comprehensive (Loss) Income for Pension and Other Postretirement Benefit Plans	$(142)	$637	$471

89

Schedule of Defined Benefit Plan Disclosures

	Employees' Pension Plan	Select Executive Retirement Plan	Postretirement Benefit Plans
For the Year Ended December 31, 2011			
Net Unamortized Loss Arising During the Period	$5,474	$151	$504
Net Prior Service Cost Arising During the Period	191	75	—
Amortization of Net Loss	(778)	(147)	(71)
Amortization of Prior Service (Cost) Credit	(38)	32	114
Total Other Comprehensive (Loss) Income for Pension and Other Postretirement Benefit Plans	$4,849	$111	$547
Accumulated Other Comprehensive Income			
December 31, 2013			
Net Actuarial Loss	$8,357	$1,674	$1,060
Prior Service (Credit) Cost	(255)	642	(305)
Total Accumulated Other Comprehensive Income, Before Tax	$8,102	$2,316	$755
December 31, 2012			
Net Actuarial Loss	$18,026	$2,368	$2,850
Prior Service (Credit) Cost	(218)	721	(419)
Total Accumulated Other Comprehensive Income, Before Tax	$17,808	$3,089	$2,431
Amounts that will be Amortized from Accumulated Other Comprehensive Income the Next Year			
Net Actuarial Loss	$345	$90	$26
Prior Service (Credit) Cost	$(45)	$72	$(114)
Net Periodic Benefit Cost			
For the Year Ended December 31, 2013			
Service Cost	$1,506	$—	$211
Interest Cost	1,261	163	308
Expected Return on Plan Assets	(2,889)	—	—
Amortization of Prior Service (Credit) Cost	37	79	(114)
Amortization of Net Loss	1,232	139	142
Net Periodic Benefit Cost	$1,147	$381	$547
For the Year Ended December 31, 2012			
Service Cost	$1,467	$87	$202
Interest Cost	1,436	190	338
Expected Return on Plan Assets	(2,865)	—	—
Amortization of Prior Service (Credit) Cost	41	53	(114)
Amortization of Net Loss	1,387	156	134
Net Periodic Benefit Cost	$1,466	$486	$560
For the Year Ended December 31, 2011			
Service Cost	$1,353	$81	$173
Interest Cost	1,598	222	372
Expected Return on Plan Assets	(2,793)	—	—

Amortization of Prior Service (Credit) Cost	38	(32)	(114)
Amortization of Net Loss	778	147	71
Net Periodic Benefit Cost	$974	$418	$502
Weighted-Average Assumptions Used in Calculating Benefit Obligation			
December 31, 2013			
Discount Rate	5.10%	4.85%	5.10%
Rate of Compensation Increase	3.50%	3.50%	3.50%

90

Schedule of Defined Benefit Plan Disclosures

	Employees' Pension Plan	Select Executive Retirement Plan	Postretirement Benefit Plans
Interest Rate Credit for Determining Projected Cash Balance Account	4.00 %		
Interest Rate to Annuitize Cash Balance Account	5.25 %		
Interest Rate to Convert Annuities To Actuarially Equivalent Lump Sum Amounts	5.25 %	5.25 %	
December 31, 2012			
Discount Rate	3.55 %	3.15 %	3.55 %
Rate of Compensation Increase	3.50 %	3.50 %	3.50 %
Interest Rate Credit for Determining Projected Cash Balance Account	3.00 %		
Interest Rate to Annuitize Cash Balance Account	4.50 %		
Interest Rate to Convert Annuities To Actuarially Equivalent Lump Sum Amounts	4.50 %	4.50 %	
Weighted-Average Assumptions Used in Calculating Net Periodic Benefit Cost			
December 31, 2013			
Discount Rate	3.55 %	3.15 %	3.55 %
Expected Long-Term Return on Plan Assets	7.50 %		
Rate of Compensation Increase	3.50 %	3.50 %	3.50 %
Interest Rate Credit for Determining Projected Cash Balance Account	3.00 %		
Interest Rate to Annuitize Cash Balance Account	4.50 %		
Interest Rate to Convert AnnuitiesTo Actuarially Equivalent Lump Sum Amounts	4.50 %	4.50 %	
December 31, 2012			
Discount Rate	4.05 %	4.05 %	4.05 %
Expected Long-Term Return on Plan Assets	7.50 %		
Rate of Compensation Increase	3.50 %	3.50 %	3.50 %
Interest Rate Credit for Determining Projected Cash Balance Account	3.25 %		
Interest Rate to Annuitize Cash Balance Account	5.00 %		
Interest Rate to Convert AnnuitiesTo Actuarially Equivalent Lump Sum Amounts	5.00 %	5.00 %	
December 31, 2011			
Discount Rate	5.15 %	5.15 %	5.15 %
Expected Long-Term Return on Plan Assets	7.50 %		

Rate of Compensation Increase	3.50 %	3.50 %	3.50 %
Interest Rate Credit for Determining Projected Cash Balance Account	4.25 %		
Interest Rate to Annuitize Cash Balance Account	5.50 %		
Interest Rate to Convert AnnuitiesTo Actuarially Equivalent Lump Sum Amounts	5.50 %	5.50 %	

91

Schedule of Defined Benefit Plan Disclosures
Information about Defined Benefit Plan Assets - Employees' Pension Plan

Asset Category	Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Percent of Total		Target Allocation Minimum		Target Allocation Maximum	
December 31, 2013										
Cash	$7	$—	$—	$7	—	%	—	%	15.0	%
Interest-Bearing Money Market Fund	3,941	—	—	3,941	8.8	%	—	%	15.0	%
Arrow Common Stock[1]	4,291	—	—	4,291	9.6	%	—	%	10.0	%
North Country Funds - Equity [2]	17,419	—	—	17,419	39.1	%				
Other Mutual Funds - Equity	14,338	—	—	14,338	32.1	%				
Total Equity Funds	31,757	—	—	31,757	71.2	%	55.0	%	85.0	%
North Country Funds - Fixed income [2]	4,309	—	—	4,309	9.6	%				
Other Mutual Funds - Fixed Income	348	—	—	348	0.8	%				
Total Fixed Income Funds	4,657	—	—	4,657	10.4	%	10.0	%	30.0	%
Total	$44,653	$—	$—	$44,653	100.0	%				
December 31, 2012										
Cash	$17	$—	$—	$17	—	%	—	%	15.0	%
Interest-Bearing Money Market Fund	5,236	—	—	5,236	13.1	%	—	%	15.0	%
Arrow Common Stock	4,197	—	—	4,197	10.5	%	—	%	10.0	%
North Country Funds - Equity [2]	13,043	—	—	13,043	32.8	%				
Other Mutual Funds - Equity	11,160	—	—	11,160	28.0	%				
Total Equity Funds	24,203	—	—	24,203	60.8	%	55.0	%	85.0	%
North Country Funds - Fixed income [2]	4,236	—	—	4,236	10.6	%				
Other Mutual Funds - Fixed Income	1,991	—	—	1,991	5.0	%				
Total Fixed Income Funds	6,227	—	—	6,227	15.6	%	10.0	%	30.0	%
Total	$39,880	$—	$—	$39,880	100.0	%				

[1] Acquisition of Arrow Financial Corporation common stock was under 10% of the total fair value of the employee's pension plan assets at the time of acquisition.
[2] The North Country Funds - Equity and the North Country Funds - Fixed Income are publicly traded mutual funds advised by Arrow's subsidiary, North Country Investment Advisers, Inc.

92

Schedule of Defined Benefit Plan Disclosures

	Employees' Pension Plan	Select Executive Retirement Plan	Postretirement Benefit Plans	
Expected Future Benefit Payments				
2014	$3,068	$452	$510	
2015	2,047	440	531	
2016	2,344	416	539	
2017	2,252	402	549	
2018	2,165	388	562	
2019-2023	12,516	1,699	3,026	
Estimated Contributions During 2014	$—	$452	$510	
Assumed Health Care Cost Trend Rates				
December 31, 2013				
Health Care Cost Trend Rate Assumed for Next Year			8.50	%
Rate to which the Cost Trend Rate is Assumed to Decline (the Ultimate Trend Rate)			5.00	%
Year that the Rate Reaches the Ultimate Trend Rate			2021	
December 31, 2012				
Health Care Cost Trend Rate Assumed for Next Year			9.00	%
Rate to which the Cost Trend Rate is Assumed to Decline (the Ultimate Trend Rate)			5.00	%
Year that the Rate Reaches the Ultimate Trend Rate			2021	
Effect of a One-Percentage Point Change in Assumed Health Care Cost Trend Rates				
Effect of a One Percentage Point Increase on Service and Interest Cost Components			$59	
Effect of a One Percentage Point Decrease on Service and Interest Cost Components			(49	)
Effect of a One Percentage Point Increase on Accumulated Postretirement Benefit Obligation			557	
Effect of a One Percentage Point Decrease on Accumulated Postretirement Benefit Obligation			(478	)

Fair Value of Plan Assets (Defined Benefit Plan):

For information on fair value measurements, including descriptions of level 1, 2 and 3 of the fair value hierarchy and the valuation methods employed by Arrow, see Note 2 - “Summary of Significant Accounting Policies” and Note 17 - “Fair Values.”

The fair value of level 1 financial instruments in the table above are based on unadjusted, quoted market prices from exchanges in active markets.

In accordance with ERISA guidelines, the Board authorized the purchase of Arrow common stock up to 10% of the fair market value of the plan's assets at the time of acquisition.

Pension Plan Investment Policies and Strategies:

The Company maintains a non-contributory pension benefit plan covering substantially all employees for the purpose of rewarding long and loyal service to the Company. The pension assets are held in trust and are invested in a prudent manner for the exclusive purpose of providing benefits to participants. The investment objective is to achieve an inflation-protected rate of return that meets the actuarial assumption which is used for funding purposes. The investment strategy attempts to maximize the investment return on assets at a level of risk deemed appropriate by the Company while complying with ERISA and any applicable regulations and laws. The investment strategy utilizes asset allocation as a principal determinant for establishing the risk/reward profile of the assets. Asset allocation ranges are established, periodically reviewed, and adjusted as funding levels, and participant benefit characteristics change. Active and passive investment management is employed to help enhance the risk/return profile of the assets.

The Plan's assets are invested in a diversified portfolio of equity securities comprised of companies with small, mid, and large capitalizations. Both domestic and international equities are allowed to provide further diversification and opportunity for return in potentially higher growth economies with lower correlation of returns. Growth and value styles of investment are employed to increase the diversification and offer varying opportunities for appreciation. The fixed income portion of the plan may be invested in U.S. dollar denominated debt securities that shall be rated within the top four ratings categories by nationally recognized ratings agencies. The fixed income portion will be invested without regard to industry or sector based on analysis of each target security's structural and repayment features, current pricing and trading opportunities as well as credit quality of the issuer. Individual bonds with ratings that fall below the Plan's rating requirements will be sold only when it is in the best interests of the Plan. Hybrid investments, such as convertible bonds, may be used to provide growth characteristics while offering some protection to declining equity markets by having a fixed income component. Alternative investments such as Treasury Inflation Protected Securities, commodities, and REITs may be used to further enhance diversification while offering opportunities for return. In accordance with ERISA guidelines, common stock of the Company may be purchased up to 10% of the fair market value of the Plan's assets at the time of acquisition. Derivative investments are prohibited in the plan.

The return on assets assumption was developed through review of historical market returns, historical asset class volatility and correlations, current market conditions, the Plan's past experience, and expectations on potential future market returns. The assumption represents a long-term average view of the performance of the assets in the Plan, a return that may or may not be achieved during any one calendar year. The assumption is based on the return of the Plan using the historical 15 year return adjusted for the potential for lower than historical returns due to low interest rates, and an expected modest recovery in global economic growth as a result of the deep recession.

Cash Flows - We were not required to make any contribution to our qualified pension plan in 2013. Arrow makes contributions for its postretirement benefits in an amount equal to actual expenses for the year.

Note 14: OTHER EXPENSES (Dollars In Thousands)

Other operating expenses included in the consolidated statements of income are as follows:

	2013	2012	2011
Computer Services	$3,261	$2,263	$1,654
Legal and Other Professional Fees	1,823	1,962	1,972
Postage and Courier	1,046	1,040	1,088
Stationery and Printing	905	975	891
Advertising and Promotion	879	831	853
Telephone and Communications	804	808	981

Intangible Asset Amortization	452	518	510
All Other	3,486	3,243	3,095
Total Other Operating Expense	$12,656	$11,640	$11,044

94

Note 15: INCOME TAXES (Dollars In Thousands)

The provision for income taxes is summarized below:

Current Tax Expense:	2013	2012	2011
Federal	$7,933	$8,763	$6,726
State	852	1,251	816
Total Current Tax Expense	8,785	10,014	7,542
Deferred Tax Expense (Benefit):			
Federal	172	(290)	1,775
State	122	(63)	397
Total Deferred Tax Expense (Benefit)	294	(353)	2,172
Total Provision for Income Taxes	$9,079	$9,661	$9,714

The provisions for income taxes differed from the amounts computed by applying the U.S. Federal Income Tax Rate of 35% for 2013, 2012 and 2011 to pre-tax income as a result of the following:

	2013	2012	2011
Computed Tax Expense at Statutory Rate	$10,806	$11,144	$11,076
Increase (Decrease) in Income Taxes Resulting From:			
Tax-Exempt Income	(2,238)	(2,132)	(2,199)
Nondeductible Interest Expense	80	95	152
State Taxes, Net of Federal Income Tax Benefit	633	814	788
Other Items, Net	(202)	(260)	(103)
Total Provision for Income Taxes	$9,079	$9,661	$9,714

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2013 and 2012 are presented below:

	2013	2012
Deferred Tax Assets:		
Allowance for Loan Losses	$5,794	$6,105
Pension and Deferred Compensation Plans	3,999	4,140
Pension Liability Included in Accumulated Other Comprehensive Income	4,426	9,241
Other	566	608
Total Gross Deferred Tax Assets	14,785	20,094
Valuation Allowance for Deferred Tax Assets	—	—
Total Gross Deferred Tax Assets, Net of Valuation Allowance	$14,785	$20,094
Deferred Tax Liabilities:		
Pension Plans	$7,724	$8,178
Depreciation	1,561	1,475
Deferred Income	3,526	3,189
Net Unrealized Gains on Securities Available-for-Sale Included in Accumulated Other Comprehensive Income	1,557	3,690
Goodwill	5,230	5,225
Total Gross Deferred Tax Liabilities	$19,598	$21,757

Management believes that the realization of the recognized net deferred tax assets at December 31, 2013 and 2012 is more likely than not, based on existing loss carryback ability, available tax planning strategies and expectations as to

future taxable income.
Interest and penalties are recorded as a component of the provision for income taxes, if any. Tax years 2010 through 2013 are subject to Federal and New York State examination.

Note 16: EARNINGS PER SHARE (In Thousands, Except Per Share Amounts)

The following table presents a reconciliation of the numerator and denominator used in the calculation of basic and diluted earnings per common share ("EPS") for each of the years in the three-year period ended December 31, 2013. All share and per share amounts have been adjusted for the 2013 2% stock dividend.

Earnings Per Share

	Year-to-Date Period Ended:		
	12/31/2013	12/31/2012	12/31/2011
Earnings Per Share - Basic:			
Net Income	$21,795	$22,179	$21,933
Weighted Average Shares - Basic	12,296	12,247	12,209
Earnings Per Share - Basic	$1.77	$1.81	$1.80
Earnings Per Share - Diluted:			
Net Income	$21,795	$22,179	$21,933
Weighted Average Shares - Basic	12,296	12,247	12,209
Dilutive Average Shares Attributable to Stock Options	31	10	12
Weighted Average Shares - Diluted	12,327	12,257	12,221
Earnings Per Share - Diluted	$1.77	$1.81	$1.79
Antidilutive Shares Excluded from the Calculation of Earnings Per Share	47	203	136

Note 17: FAIR VALUES (Dollars In Thousands)

FASB ASC Subtopic 820-10 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and requires certain disclosures about fair value measurements. We do not have any nonfinancial assets or liabilities measured at fair value on a recurring basis. The only assets or liabilities that Arrow measured at fair value on a recurring basis at December 31, 2013 and 2012 were securities available-for-sale. Arrow held no securities or liabilities for trading on such date. For information on fair value measurements, including descriptions of level 1, 2 and 3 of the fair value hierarchy and the valuation methods employed by Arrow, see Note 2 - “Summary of Significant Accounting Policies.”

The table below presents the financial instrument's fair value and the amounts within the fair value hierarchy based on the lowest level of input that is significant to the fair value measurement:

Fair Value of Assets and Liabilities Measured on a Recurring and Nonrecurring Basis

	Fair Value Measurements at Reporting Date Using:				
Fair Value of Assets and Liabilities Measured on a Recurring Basis:	Fair Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses)
December 31, 2013					
Securities Available-for Sale:					
U.S. Agency Obligations	$136,475	$—	$136,475	$—	
State and Municipal Obligations	127,389	—	127,389	—	
Mortgage-Backed Securities - Residential	175,778	—	175,778	—	
Corporate and Other Debt Securities	16,798	—	16,798	—	
Mutual Funds and Equity Securities	1,166	—	1,166	—	
Total Securities Available-for-Sale	$457,606	$—	$457,606	$—	
December 31, 2012					
Securities Available-for Sale:					
U.S. Agency Obligations	$122,457	$—	$122,457	$—	
State and Municipal Obligations	84,838	—	84,838	—	
Mortgage-Backed Securities - Residential	261,804	—	261,804	—	
Corporate and Other Debt Securities	8,451	—	8,451	—	
Mutual Funds and Equity Securities	1,148	—	1,148	—	
Total Securities Available-for Sale	$478,698	$—	$478,698	$—	
Fair Value of Assets and Liabilities Measured on a Nonrecurring Basis:					
December 31, 2013					
Other Real Estate Owned and Repossessed Assets, Net	$144	$—	$—	$144	$(79)
December 31, 2012					
Collateral Dependent Impaired Loans	$1,020	$—	$—	$1,020	$(1,021)
Other Real Estate Owned and Repossessed Assets, Net	$1,034	$—	$—	$1,034	$(19)

We determine the fair value of financial instruments under the following hierarchy:

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

Fair Value Methodology for Assets and Liabilities Measured on a Recurring Basis

The fair value of level 1 securities available-for-sale are based on unadjusted, quoted market prices from exchanges in active markets. The fair value of level 2 securities available-for-sale are based on an independent bond and equity pricing service for identical assets or significantly similar securities and an independent equity pricing service for equity securities not actively traded. The pricing services use a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows.

Fair Value Methodology for Assets and Liabilities Measured on a Nonrecurring Basis

The fair value of collateral dependent impaired loans and other real estate owned was based on third-party appraisals. The appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses ranging from 10% to 35%.

97

Other assets which might have been included in this table include mortgage servicing rights, goodwill and other intangible assets. Arrow evaluates each of these assets for impairment on an annual basis, with no impairment recognized for these assets at December 31, 2013 and December 31, 2012.

Fair Value by Balance Sheet Grouping

The following table presents a summary of the carrying amount, the fair value or an amount approximating fair value and the fair value hierarchy of Arrow's financial instruments:
Schedule of Fair Values by Balance Sheet Grouping

			Fair Value Hierarchy		
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
December 31, 2013					
Cash and Cash Equivalents	$49,980	$49,980	$49,980	$—	$—
Securities Available-for-Sale	457,606	457,606	—	457,606	—
Securities Held-to-Maturity	299,261	302,305	—	302,305	—
Federal Home Loan Bank and Federal Reserve Bank Stock	6,281	6,281	6,281	—	—
Net Loans	1,252,038	1,266,020	—	—	1,266,020
Accrued Interest Receivable	5,745	5,745	5,745	—	—
Deposits	1,842,330	1,839,613	1,595,103	244,510	—
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	11,777	11,777	11,777	—	—
Federal Home Loan Bank Term Advances	73,000	74,629	53,000	21,629	—
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000	—	20,000	—
Accrued Interest Payable	439	439	439	—	—
December 31, 2012					
Cash and Cash Equivalents	$48,832	$48,832	$48,832	$—	$—
Securities Available-for-Sale	478,698	478,698	—	478,698	—
Securities Held-to-Maturity	239,803	248,252	—	248,252	—
Federal Home Loan Bank and Federal Reserve Bank Stock	5,792	5,792	5,792	—	—
Net Loans	1,157,043	1,192,628	—	—	1,192,628
Accrued Interest Receivable	5,486	5,486	5,486	—	—
Deposits	1,731,155	1,732,894	1,447,882	285,012	—
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	12,678	12,678	12,678	—	—
Federal Home Loan Bank Term Advances	59,000	60,312	29,000	31,312	—
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000	—	20,000	—
Accrued Interest Payable	584	584	584	—	—

Fair Value Methodology for Financial Instruments Not Measured on a Recurring or Nonrecurring Basis

Securities held-to-maturity are fair valued utilizing an independent bond pricing service for identical assets or significantly similar securities. The pricing service uses a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows.

Fair values for loans are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial real estate, residential mortgage, indirect and other consumer loans. Each loan category is further segmented into fixed and adjustable interest rate terms and by performing and nonperforming categories. The fair value methodology does not use an exit price methodology. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions. Fair value for nonperforming loans is generally based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

The fair value of time deposits is based on the discounted value of contractual cash flows, except that the fair value is limited to the extent that the customer could redeem the certificate after imposition of a premature withdrawal penalty. The discount rates are estimated using the FHLBNY yield curve, which is considered representative of Arrow's time deposit rates. The fair value of all other deposits is equal to the carrying value.

The fair value of FHLBNY advances is estimated based on the discounted value of contractual cash flows. The discount rate is estimated using current rates on FHLBNY advances with similar maturities and call features.

Based on Arrow's capital adequacy, the book value of the outstanding trust preferred securities (Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts) are considered to approximate fair value since the interest rates are variable (indexed to LIBOR) and Arrow is well-capitalized.

Note 18: LEASES (Dollars In Thousands)

At December 31, 2013, Arrow was obligated under a number of noncancellable operating leases for buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed.
Net rental expense for the years ended December 31, 2013, 2012 and 2011 was as follows:

	2013	2012	2011
Net Rental Expense	$671	$597	$570

Future minimum lease payments on operating leases at December 31, 2013 were as follows:

	Operating Leases
2014	$638
2015	583
2016	440
2017	347
2018	277
Later Years	448
Total Minimum Lease Payments	$2,733

Arrow leases five of its branch offices, at market rates, from Stewart's Shops Corp. Mr. Gary C. Dake, President of Stewart's Shops Corp., serves on both the boards of Arrow and Saratoga National Bank and Trust Company.

Note 19: REGULATORY MATTERS (Dollars in Thousands)

In the normal course of business, Arrow and its subsidiaries operate under certain regulatory restrictions, such as the extent and structure of covered inter-company borrowings and maintenance of reserve requirement balances.

The principal source of the funds for the payment of stockholder dividends by Arrow has been from dividends declared and paid to Arrow by its bank subsidiaries. As of December 31, 2013, the maximum amount that could have been paid by subsidiary banks to Arrow, without prior regulatory approval, was approximately $26,668.

Under current Federal Reserve regulations, Arrow is prohibited from borrowing from the subsidiary banks unless such borrowings are secured by specific obligations. Additionally, the maximum of any such borrowing is limited to 10% of an affiliate's capital and surplus.

Arrow and its subsidiary banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory--and possibly additional discretionary--actions by regulators that, if undertaken, could have a direct material effect on an institution's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Arrow and its subsidiary banks must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require Arrow and its subsidiary banks to maintain minimum capital amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2013 and 2012, that Arrow and both subsidiary banks meet all capital adequacy requirements to which they are subject.

As of December 31, 2013, Arrow and both subsidiary banks qualified as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized," Arrow and its subsidiary banks must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. There are no conditions or events that management believes have changed Arrow's or its subsidiary banks' categories.

Arrow's and its subsidiary banks', Glens Falls National Bank and Trust Company ("Glens Falls National") and Saratoga National Bank and Trust Company ("Saratoga National"), actual capital amounts and ratios are presented in the table below as of December 31, 2013 and 2012:

	Actual			Minimum Amounts For Capital Adequacy Purposes			Minimum Amounts To Be Well-Capitalized		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
As of December 31, 2013:									
Total Capital (to Risk Weighted Assets):									
Arrow	$212,360	15.8	%	$107,524	8.0	%	$134,405	10.0	%
Glens Falls National	172,720	15.4	%	89,725	8.0	%	112,156	10.0	%
Saratoga National	33,396	14.8	%	18,052	8.0	%	22,565	10.0	%
Tier I Capital (to Risk Weighted Assets):									
Arrow	197,906	14.7	%	53,852	4.0	%	80,778	6.0	%
Glens Falls National	160,849	14.4	%	44,680	4.0	%	67,020	6.0	%
Saratoga National	30,833	13.7	%	9,002	4.0	%	13,504	6.0	%
Tier I Capital (to Average Assets):									
Arrow	197,906	9.2	%	86,046	4.0	%	86,046	4.0	%
Glens Falls National	160,849	8.8	%	73,113	4.0	%	91,391	5.0	%
Saratoga National	30,833	9.7	%	12,715	4.0	%	15,893	5.0	%

	Actual			Minimum Amounts For Capital Adequacy Purposes			Minimum Amounts To Be Well-Capitalized		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
As of December 31, 2012:									
Total Capital (to Risk Weighted Assets):									
Arrow	$200,480	16.3	%	98,395	8.0	%	122,994	10.0	%
Glens Falls National	164,889	16.2	%	81,427	8.0	%	101,783	10.0	%
Saratoga National	31,911	15.1	%	16,906	8.0	%	21,133	10.0	%
Tier I Capital (to Risk Weighted Assets):									
Arrow	185,170	15.0	%	49,379	4.0	%	74,068	6.0	%
Glens Falls National	152,205	14.9	%	40,860	4.0	%	61,291	6.0	%

Saratoga National	29,297	13.8	%	8,492	4.0	%	12,738	6.0	%
Tier I Capital (to Average Assets):									
Arrow	185,170	9.1	%	81,393	4.0	%	81,393	4.0	%
Glens Falls National	152,205	8.8	%	69,184	4.0	%	86,480	5.0	%
Saratoga National	29,297	9.4	%	12,467	4.0	%	15,584	5.0	%

Note 20: PARENT ONLY FINANCIAL INFORMATION (Dollars In Thousands)

Condensed financial information for Arrow Financial Corporation is as follows:

BALANCE SHEETS	December 31,	
ASSETS	2013	2012
Interest-Bearing Deposits with Subsidiary Banks	$3,349	$1,913
Available-for-Sale Securities	1,166	1,148
Held-to-Maturity Securities	1,000	1,000
Investment in Subsidiaries at Equity	206,680	192,985
Other Assets	5,807	5,339
Total Assets	$218,002	$202,385
LIABILITIES		
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	$20,000	$20,000
Other Liabilities	5,848	6,560
Total Liabilities	25,848	26,560
STOCKHOLDERS' EQUITY		
Total Stockholders' Equity	192,154	175,825
Total Liabilities and Stockholders' Equity	$218,002	$202,385

STATEMENTS OF INCOME	Years Ended December 31,		
Income:	2013	2012	2011
Dividends from Bank Subsidiaries	$12,900	$12,700	$14,450
Interest and Dividends on Investments	116	123	127
Other Income (Including Management Fees)	549	776	596
Net Gains on Securities Transactions	—	63	17
Total Income	13,565	13,662	15,190
Expense:			
Interest Expense	640	692	669
Salaries and Employee Benefits	59	75	92
Other Expense	860	957	820
Total Expense	1,559	1,724	1,581
Income Before Income Tax Benefit and Equity in Undistributed Net Income of Subsidiaries	12,006	11,938	13,609
Income Tax Benefit	634	575	477
Equity in Undistributed Net Income of Subsidiaries	9,155	9,666	7,847
Net Income	$21,795	$22,179	$21,933

The Statement of Changes in Stockholders' Equity is not reported because it is identical to the Consolidated Statement of Changes in Stockholders' Equity.

STATEMENTS OF CASH FLOWS	Years Ended December 31,		
	2013	2012	2011
Cash Flows from Operating Activities:			
Net Income	$21,795	$22,179	$21,933
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Undistributed Net Income of Subsidiaries	(9,155)	(9,666)	(7,847)
Net Gains on the Sale of Securities Available-for-Sale	—	(63)	(17)
Shares Issued Under the Directors' Stock Plan	198	175	175
Stock-Based Compensation Expense	372	424	354
Changes in Other Assets and Other Liabilities	(990)	(1,640)	(165)
Net Cash Provided by Operating Activities	12,220	11,409	14,433
Cash Flows from Investing Activities:			
Proceeds from the Sale of Securities Available-for-Sale	45	681	410
Purchases of Securities Available-for-Sale	(45)	(359)	(253)
Net Cash Provided by Investing Activities	—	322	157
Cash Flows from Financing Activities:			
Stock Options Exercised	1,254	2,105	1,413
Shares Issued Under the Employee Stock Purchase Plan	477	484	474
Shares Issued for Dividend Reinvestment Plans	1,280	1,822	1,796
Tax Benefit for Exercises of Stock Options	23	68	51
Purchase of Treasury Stock	(1,709)	(4,877)	(6,039)
Cash Dividends Paid	(12,109)	(11,815)	(11,448)
Net Cash Used in Financing Activities	(10,784)	(12,213)	(13,753)
Net (Decrease) Increase in Cash and Cash Equivalents	1,436	(482)	837
Cash and Cash Equivalents at Beginning of the Year	1,913	2,395	1,558
Cash and Cash Equivalents at End of the Year	$3,349	$1,913	$2,395
Supplemental Disclosures to Statements of Cash Flow Information:			
Interest Paid	$640	$692	$669
Non-cash Investing and Financing Activities:			
Shares Issued for Acquisition of Subsidiary	233	233	5,261

102

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure - None.

Item 9A. Controls and Procedures

Senior management maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods provided in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, senior management has recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and therefore has been required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Senior management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13(a)-15(e) under the Exchange Act) as of December 31, 2013. Based upon that evaluation, senior management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective on that date. There were no changes made in our internal controls or in other factors that could significantly affect these internal controls subsequent to the date of the evaluation performed by the Chief Executive Officer and Chief Financial Officer.

Management’s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in the Exchange Act Rules 13(a)-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an assessment of the effectiveness of our internal control over financial reporting. Our evaluation is based on the framework set forth in Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, our management concluded that our internal control over financial reporting was effective as of December 31, 2013.

Item 9B. Other Information – None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item regarding directors, nominees for director, and the committees of the Company's Board is set forth under the captions "Voting Item 1: Election of Directors" and “Corporate Governance” of Arrow's Proxy Statement for its Annual Meeting of Shareholders to be held May 7, 2014 (the Proxy Statement), which sections are incorporated herein by reference. Information regarding Compliance with Section 16(a) of the Exchange Act is set forth in the Company's Proxy Statement under the caption "Section 16(a) Beneficial Ownership Reporting” and is incorporated herein by reference. Certain required information regarding our Executive Officers is contained in Part I, Item 1.G., of this Report, "Executive Officers of the Registrant." Arrow has adopted a Financial Code of Ethics applicable to our principal executive officer, principal financial officer and principal accounting officer, a copy of which can be found on our website at www.arrowfinancial.com under the link "Corporate Governance."

Item 11. Executive Compensation

The information required by this item is set forth under the captions “Corporate Governance - Director Independence,” "Compensation Discussion and Analysis” including the “Compensation Committee Report” thereof, “Executive Compensation,” “Agreements with Executive Officers” including the ”Potential Payments Upon Termination or Change of Control” and “Potential Payments Table” sections thereof, and “Voting Item 1: Election of Directors - Director Compensation” of the Proxy Statement, which sections are incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Certain information required by this item is set forth under the caption "Stock Ownership Information" of the Proxy Statement, which section is incorporated herein by reference, and under the caption "Equity Compensation Plan Information" in Part II of this Form 10-K on page 18.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item is set forth under the captions “Corporate Governance - Related Party Transactions” and “Corporate Governance - Director Independence” of the Proxy Statement, which sections are incorporated herein by reference.

Item 14. Principal Accounting Fees and Services
The information required by this item is set forth under the captions "Voting Item 3 - Ratification of Independent Registered Public Accounting Firm - Independent Registered Public Accounting Firm Fees," and “Corporate Governance - Board Committees” of the Proxy Statement, which sections are incorporated herein by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules

1. Financial Statements

The following financial statements, the notes thereto, and the independent auditors’ report thereon are filed in Part II, Item 8 of this report. See the index to such financial statements at the beginning of Item 8.

Reports of Independent Registered Public Accounting Firm
Consolidated Balance Sheets as of December 31, 2013 and 2012
Consolidated Statements of Income for the Years Ended December 31, 2013, 2012 and 2011
Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2013, 2012 and 2011
Consolidated Statements of Changes in Stockholders’Equity for the Years Ended December 31, 2013, 2012 and 2011
Consolidated Statements of Cash Flows for the Years Ended December 31, 2013, 2012 and 2011
Notes to Consolidated Financial Statements

2. Schedules

All schedules are omitted as the required information is either not applicable or not required or is contained in the respective financial statements or in the notes thereto.

3. Exhibits:

See Exhibit Index on page 106.

Pursuant to the requirements of Section 13 or 15(d) 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.

ARROW FINANCIAL CORPORATION

Date: March 14, 2014	By /s/ Thomas J. Murphy Thomas J. Murphy President and Chief Executive Officer
Date: March 14, 2014	By: /s/ Terry R. Goodemote Terry R. Goodemote Executive Vice President, Treasurer and Chief Financial Officer (Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on March 14, 2014 by the following persons in the capacities indicated.

/s/ John J. Carusone, Jr. John J. Carusone, Jr. Director	/s/ Elizabeth O'C. Little Elizabeth O'C. Little Director
/s/ Tenee R. Casaccio Tenee R. Casaccio Director	/s/ David L. Moynehan David L. Moynehan Director
/s/ Michael B. Clarke Michael B. Clarke Director	/s/ John J. Murphy John J. Murphy Director
/s/ Gary C. Dake Gary C. Dake Director	/s/ Thomas J. Murphy Thomas J. Murphy Director
/s/ Thomas L. Hoy Thomas L. Hoy Director and Chairman	/s/ Colin L. Reed Colin L. Reed Director
/s/ David G. Kruczlnicki David G. Kruczlnicki Director	/s/ Richard J. Reisman, D.M.D. Richard J. Reisman, D.M.D. Director

EXHIBIT INDEX

The following exhibits are incorporated by reference herein.

Exhibit Number	Exhibit
3.(i)	Certificate of Incorporation of the Registrant, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2007, Exhibit 3.(i)
3.(ii)	By-laws of the Registrant, as amended, incorporated herein by reference from the Registrant's Current Report on Form 8-K filed on November 24, 2009, Exhibit 3.(ii)
4.1	Amended and Restated Declaration of the Trust by and among U.S. Bank National Association, as Institutional Trustee, the Registrant, as Sponsor and certain Administrators named therein, dated as of July 23, 2003, relating to Arrow Capital Statutory Trust II, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.1
4.2	Indenture between the Registrant, as Issuer, and U.S. Bank National Association, as Trustee, dated as of July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.2
4.3	Placement Agreement by and among the Registrant, Arrow Capital Statutory Trust II and SunTrust Capital Markets, Inc., dated July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.3
4.4	Guarantee Agreement by and between the Registrant and U.S. Bank National Association, dated as of July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.4
4.5	Amended and Restated Trust Agreement among the Registrant, as Depositor, Wilmington Trust Company, as Property Trustee, Wilmington Trust Company, as Delaware trustee, and certain Administrators named therein, dated as of December 28, 2004, relating to Arrow Capital Statutory Trust III, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.6
4.6	Junior Subordinated Indenture between the Registrant, as Issuer, and Wilmington Trust Company, as Trustee, dated as of December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.7
4.7	Placement Agreement among the Registrant, Arrow Capital Statutory Trust III and SunTrust Capital Markets, Inc., dated December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.8
4.8	Guarantee Agreement between the Registrant and Wilmington Trust Company, dated as of December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.9
10.1	1998 Long Term Incentive Plan of the Registrant, incorporated herein by reference from Registrant's 1933 Act Registration Statement on Form S-8, Exhibit 4.1 (File number 333-62719; filed on September 2, 1998)*
10.2	2008 Long Term Incentive Plan of the Registrant, incorporated herein by reference from the Registrant's Current Report on Form 8-K filed on May 6, 2008, Exhibit 10.1*
10.3	2013 Long Term Incentive Plan of the Registrant, incorporated herein by reference from the Registrant's Definitive Proxy Statement on Schedule 14A filed on March 20, 2013 as Annex A*
10.4	Profit Sharing Plan of the Registrant, as amended, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2008, Exhibit 10.6*
10.5	Directors' Deferred Compensation Plan of the Registrant, as amended and restated, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2008, Exhibit 10.7*
10.6	

	Directors' Stock Plan of the Registrant incorporated herein by reference from the Registrant's Definitive Proxy Statement on Schedule 14A filed on March 20, 2013 as Annex B*
10.7	Select Executive Retirement Plan of the Registrant for benefits accrued or vested after December 31, 2004, as amended and restated, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2008, Exhibit 10.9*
10.8	Select Executive Retirement Plan of the Registrant for benefits accrued or vested on or before December 31, 2004, as amended and restated, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2008, Exhibit 10.10*
10.9	Senior Officers Deferred Compensation Plan of the Registrant, as amended, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2008, Exhibit 10.11*
10.10	Short Term Incentive Plan of the Registrant, as amended, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2008, Exhibit 10.12*

106

Exhibit Number	Exhibit
10.11	Consulting Agreement between the Registrant and Thomas L. Hoy, effective January 1, 2013 incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2012, Exhibit 10.13
10.12	Employment Agreement between the Registrant and Thomas J. Murphy, President and Chief Executive Officer, effective February 1, 2014 incorporated herein by reference from the Registrant's Current Report on Form 8-K , filed February 4, 2014, Exhibit 10.1*
10.13	Employment Agreement between the Registrant and Terry R. Goodemote, Executive Vice President and Chief Financial Officer, effective February 1, 2014 incorporated herein by reference from the Registrant's Current Report on Form 8-K, filed February 4, 2014, Exhibit 10.2*
10.14	Employment Agreement between the Registrant and David S. DeMarco, Senior Vice President, effective February 1, 2014 incorporated herein by reference from the Registrant's Current Report on Form 8-K , filed February 4, 2014, Exhibit 10.3*
14	Financial Code of Ethics, incorporated herein by reference from the Registrant’s Annual Report on Form 10-K for the year ended December 31, 2003, Exhibit 14

The following exhibits are submitted herewith:

Exhibit Number	Exhibit
10.15	Form of Incentive Stock Option Certificate (Employee Award) of the Registrant*
10.16	Form of Non-Qualified Stock Option Certificate (Employee Award) of the Registrant*
10.17	Form of Non-Qualified Stock Option Certificate (Director Award) of the Registrant*
10.18	Amendment dated October 18, 2013 to Registrant’s Select Executive Retirement Plan for benefits accrued or vested after December 31, 2004, as amended and restated*
21	Subsidiaries of Arrow Financial Corporation
23	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer under SEC Rule 13a-14(a)/15d-14(a)
31.2	Certification of Chief Financial Officer under SEC Rule 13a-14(a)/15d-14(a)
32	Certification of Chief Executive Officer under 18 U.S.C. Section 1350 and Certification of Chief Financial Officer under 18 U.S.C. Section 1350
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

* Management contracts or compensation plans required to be filed as an exhibit.

107