EVANS BANCORP INC
Form 10-Q
May 03, 2013

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 quarterly period ended March 31, 2013

[ ] 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 001-35021

EVANS BANCORP, INC. .

(Exact name of registrant as specified in its charter)

New York 16-1332767

(State or other jurisdiction of (I.R.S. Employer

incorporation or organization) Identification No.)

One Grimsby Drive, Hamburg, NY 14075

(Address of principal executive offices) (Zip Code)

(716) 926-2000 .

(Registrant's telephone number, including area code)

14 -16 North Main Street, Angola, New York 14006 .

(Former name, former address and former fiscal year, if changed

since last report)

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 definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ] Accelerated filer [ ]

Non-accelerated filer [ ] (Do not check if smaller reporting company) Smaller reporting company [X]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Common Stock, $.50 par value: 4,190,257 shares as of April 23, 2013

Table of Contents

INDEX

EVANS BANCORP, INC. AND SUBSIDIARIES

Table of Contents

PART I - FINANCIAL INFORMATION
ITEM I - FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS
MARCH 31, 2013 AND DECEMBER 31, 2012
(in thousands, except share and per share amounts)

	March 31, 2013	December 31, 2012
ASSETS		
Cash and due from banks	$ 12,509	$ 12,409
Interest-bearing deposits at banks	88,089	78,068
Securities:		
Available for sale, at fair value (cost: $87,957 at March 31, 2013; $88,054 at December 31, 2012)	91,540	92,063
Held to maturity, at amortized cost (fair value: $3,707 at March 31, 2013; $3,721 at December 31, 2012)	3,734	3,744
Federal Home Loan Bank common stock, at amortized cost	1,489	1,804
Federal Reserve Bank common stock, at amortized cost	1,457	1,445
Loans and leases, net of allowance for loan and lease losses of $10,154 at March 31, 2013 and $9,732 at December 31, 2012	577,932	573,163
Properties and equipment, net of depreciation of $14,558 at March 31, 2013 and $14,256 at December 31, 2012	11,020	11,368
Goodwill	8,101	8,101
Intangible assets	266	329
Bank-owned life insurance	15,446	15,333
Other assets	12,131	11,849
TOTAL ASSETS	$ 823,714	$ 809,676
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Demand	$ 123,084	$ 123,405
NOW	73,016	65,753
Regular savings	391,739	380,924
Time	110,461	108,910
Total deposits	698,300	678,992
Securities sold under agreement to repurchase	13,784	12,111
Other short term borrowings	3,000	10,000
Other liabilities	11,805	13,415

Junior subordinated debentures	11,330	11,330
Long term borrowings	9,000	9,000
Total liabilities	747,219	734,848
CONTINGENT LIABILITIES AND COMMITMENTS		
STOCKHOLDERS' EQUITY:		
Common stock, \$.50 par value, 10,000,000 shares authorized; 4,190,257 and 4,171,473 shares issued and outstanding at March 31, 2013 and December 31, 2012, respectively	2,096	2,087
Capital surplus	42,095	42,029
Retained earnings	32,427	30,611
Accumulated other comprehensive (loss) gain, net of tax	(123)	101
Total stockholders' equity	76,495	74,828
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 823,714	\$ 809,676

See Notes to Unaudited Consolidated Financial Statements

1

PART I - FINANCIAL INFORMATION
ITEM I - FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF INCOME
THREE MONTHS ENDED MARCH 31, 2013 AND 2012
(in thousands, except share and per share amounts)

	Three Months Ended March 31,	
	2013	2012
INTEREST INCOME		
Loans and leases	$ 7,252	$ 7,508
Interest bearing deposits at banks	18	9
Securities:		
Taxable	417	545
Non-taxable	269	306
Total interest income	7,956	8,368
INTEREST EXPENSE		
Deposits	890	1,242
Other borrowings	161	187
Junior subordinated debentures	79	87
Total interest expense	1,130	1,516
NET INTEREST INCOME	6,826	6,852
PROVISION FOR LOAN AND LEASE LOSSES	450	(249)
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	6,376	7,101
NON-INTEREST INCOME		
Bank charges	482	436
Insurance service and fees	1,999	1,945
Data center income	114	124
Gain on loans sold	25	53
Bank-owned life insurance	113	118
Other	577	613
Total non-interest income	3,310	3,289
NON-INTEREST EXPENSE		
Salaries and employee benefits	4,289	4,214
Occupancy	816	685
Repairs and maintenance	178	169
Advertising and public relations	124	145
Professional services	454	539
Technology and communications	291	263
Amortization of intangibles	63	104
FDIC insurance	138	134
Other	723	656

Total non-interest expense	7,076	6,909
INCOME BEFORE INCOME TAXES	2,610	3,481
INCOME TAX PROVISION	794	1,102
NET INCOME	$ 1,816	$ 2,379
Net income per common share-basic	$ 0.44	$ 0.58
Net income per common share-diluted	$ 0.43	$ 0.58
Cash dividends per common share	$ -	$ 0.22
Weighted average number of common shares outstanding	4,173,978	4,126,656
Weighted average number of diluted shares outstanding	4,210,595	4,131,330

See Notes to Unaudited Consolidated Financial Statements

PART I - FINANCIAL INFORMATION
ITEM I - FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME
THREE MONTHS ENDED MARCH 31, 2013 AND 2012
(in thousands, except share and per share amounts)

	Three Months Ended March 31,	
	2013	2012
NET INCOME	$ 1,816	$ 2,379
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:		
Unrealized loss on available-for-sale securities	(261)	(115)
Defined benefit pension plans:		
Amortization of prior service cost	10	14
Amortization of actuarial loss	27	26
Total	37	40
OTHER COMPREHENSIVE LOSS, NET OF TAX	(224)	(75)
COMPREHENSIVE INCOME	$ 1,592	$ 2,304

See Notes to Unaudited Consolidated Financial Statements

PART 1 - FINANCIAL INFORMATION
ITEM 1 - FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
THREE MONTHS ENDED MARCH 31, 2013 AND
2012
(in thousands, except share and per share amounts)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total
Balance, December 31, 2011	$ 2,063	$ 41,275	$ 25,304	$ 346	$ 68,988
Net Income			2,379		2,379
Other comprehensive loss				(75)	(75)
Cash dividends ($0.22 per common share)			(908)		(908)
Stock options and restricted stock expense		71			71
Issued 4,013 restricted shares	2	(2)			-
Balance, March 31, 2012	$ 2,065	$ 41,344	$ 26,775	$ 271	$ 70,455
Balance, December 31, 2012	$ 2,087	$ 42,029	$ 30,611	$ 101	$ 74,828
Net Income			1,816		1,816
Other comprehensive loss				(224)	(224)
Stock options and restricted stock expense		75			75
Issued 18,784 restricted shares	9	(9)			-
Balance, March 31, 2013	$ 2,096	$ 42,095	$ 32,427	$ (123)	$ 76,495

See Notes to Unaudited Consolidated Financial
Statements

4

PART I-FINANCIAL INFORMATION
ITEM I-FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2013 AND 2012
(in thousands)

	Three Months Ended March 31, 2013	2012
OPERATING ACTIVITIES:		
Interest received	$ 7,638	$ 8,011
Fees received	3,301	3,107
Interest paid	(1,147)	(1,550)
Cash paid to employees and vendors	(8,009)	(7,058)
Cash contributed to pension plan	(95)	-
Income taxes paid	(461)	(720)
Proceeds from sale of loans held for resale	776	6,250
Originations of loans held for resale	(233)	(3,998)
Net cash provided by operating activities	1,770	4,042
INVESTING ACTIVITIES:		
Available for sales securities:		
Purchases	(3,487)	(17,759)
Proceeds from maturities and calls	3,759	9,009
Held to maturity securities:		
Purchases	-	(428)
Proceeds from maturities, calls, and payments	11	396
Additions to properties and equipment	(47)	(117)
Net increase (decrease) in loans	(5,865)	898
Net cash used in investing activities	(5,629)	(8,001)
FINANCING ACTIVITIES:		
Repayments of borrowings	(5,328)	(329)
Net increase in deposits	19,308	33,478
Net cash provided by financing activities	13,980	33,149
Net increase in cash and equivalents	10,121	29,190

CASH AND CASH EQUIVALENTS:		
Beginning of period	90,477	14,678
End of period	$ 100,598	$ 43,868

(continued)

5

EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2013 AND 2012
(in thousands)

	Three Months Ended March 31,	
	2013	2012
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 1,816	$ 2,379
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	567	510
Deferred tax expense	109	87
Provision for loan and lease losses	450	(249)
Premium on loans sold	(25)	(53)
Stock options and restricted stock expense	75	71
Proceeds from sale of loans held for resale	776	6,250
Originations of loans held for resale	(233)	(3,998)
Cash contributed to pension plan	(95)	-
Changes in assets and liabilities affecting cash flow:		
Other assets	(699)	227
Other liabilities	(971)	(1,182)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 1,770	$ 4,042

See Notes to Unaudited Consolidated Financial Statements

PART 1 – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED MARCH 31, 2013 AND 2012

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies followed by Evans Bancorp, Inc. (the “Company”), a financial holding company, and its two direct, wholly-owned subsidiaries: (i) Evans Bank, National Association (the “Bank”), and the Bank’s subsidiaries, Evans National Leasing, Inc. (“ENL”), Evans National Holding Corp. (“ENHC”) and Suchak Data Systems, LLC (“SDS”); and (ii) Evans National Financial Services, LLC (“ENFS”), and ENFS’s subsidiary, The Evans Agency, LLC (“TEA”), and TEA’s subsidiaries, Frontier Claims Services, Inc. (“FCS”) and ENB Associates Inc. (“ENBA”), in the preparation of the accompanying interim unaudited consolidated financial statements conform with U.S. generally accepted accounting principles (“GAAP”) and with general practice within the industries in which it operates. Except as the context otherwise requires, the Company and its direct and indirect subsidiaries are collectively referred to in this report as the “Company.”

The accompanying consolidated financial statements are unaudited. In the opinion of management, all adjustments necessary for a fair presentation of the Company’s financial position and results of operations for the interim periods have been made. Certain reclassifications have been made to the 2012 unaudited consolidated financial statements to conform to the presentation used in 2013. During the quarter ended March 31, 2013, the Company revised the three month period ended, March 31, 2012 Consolidated Statement of Cash Flows to correct a $194 thousand error within “Depreciation and Amortization” and “Changes in Other Assets Affecting Cash Flow.” The Company has assessed the materiality of this correction and concluded, based on qualitative and quantitative considerations, that the adjustments are not material to the Consolidated Statements of Cash Flows as a whole.

The results of operations for the three month period ended March 31, 2013 are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited consolidated financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date of filing.

2. SECURITIES

The amortized cost of securities and their approximate fair value at March 31, 2013 and December 31, 2012 were as follows:

	March 31, 2013 (in thousands)			
	Amortized Cost	Unrealized Gains	Losses	Fair Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 27,210	$ 995	$ (78)	$ 28,127
States and political subdivisions	32,543	1,502	(13)	34,032
Total debt securities	$ 59,753	$ 2,497	$ (91)	$ 62,159
Mortgage-backed securities:				
FNMA	$ 13,811	$ 760	$ -	$ 14,571
FHLMC	5,737	178	(7)	5,908
GNMA	7,116	221	-	7,337
CMO	1,540	25	-	1,565
Total mortgage-backed securities	$ 28,204	$ 1,184	$ (7)	$ 29,381
Total securities designated as available for sale	$ 87,957	$ 3,681	$ (98)	$ 91,540
Held to Maturity:				
Debt securities				
States and political subdivisions	3,734	19	(46)	3,707
Total securities designated as held to maturity	$ 3,734	$ 19	$ (46)	$ 3,707
Total securities	$ 91,691	$ 3,700	$ (144)	$ 95,247

	December 31, 2012 (in thousands)			
	Amortized Cost	Unrealized Gains	Losses	Fair Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 27,227	$ 1,137	$ (32)	$ 28,332
States and political subdivisions	29,912	1,567	(10)	31,469
Total debt securities	$ 57,139	$ 2,704	$ (42)	$ 59,801
Mortgage-backed securities:				
FNMA	$ 15,210	$ 867	$ -	$ 16,077
FHLMC	6,292	189	-	6,481
GNMA	7,750	263	-	8,013
CMO	1,663	28	-	1,691
Total mortgage-backed securities	$ 30,915	$ 1,347	$ -	$ 32,262
Total securities designated as available for sale	$ 88,054	$ 4,051	$ (42)	$ 92,063
Held to Maturity:				
Debt securities				
States and political subdivisions	3,744	23	(46)	3,721
Total securities designated as held to maturity	$ 3,744	$ 23	$ (46)	$ 3,721
Total securities	$ 91,798	$ 4,074	$ (88)	$ 95,784

Available for sale securities with a total fair value of $90.1 million and $68.0 million at March 31, 2013 and December 31, 2012, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

The Company uses the Federal Home Loan Bank of New York ("FHLBNY") as its primary source of overnight funds and also has several long-term advances with FHLBNY. The Company had a total of $12.0 million and $19.0 million in borrowed funds with FHLBNY at March 31, 2013 and December 31, 2012, respectively. The Company has placed sufficient collateral in the form of residential and commercial real estate loans at FHLBNY that meet FHLB collateral requirements. As a member of the Federal Home Loan Bank ("FHLB") System, the Bank is required to hold stock in

FHLBNY. The Bank held $1.5 million in FHLBNY stock as of March 31, 2013 and $1.8 million as of December 31, 2012 at amortized cost.

The scheduled maturities of debt and mortgage-backed securities at March 31, 2013 and December 31, 2012 are summarized below. All maturity amounts are contractual maturities. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call premiums.

	March 31, 2013 Amortized cost	March 31, 2013 Estimated fair value	December 31, 2012 Amortized cost	December 31, 2012 Estimated fair value
	(in thousands)		(in thousands)	
Debt securities available for sale:				
Due in one year or less	$ 2,477	$ 2,497	$ 2,766	$ 2,797
Due after one year through five years	18,231	19,016	16,797	17,561
Due after five years through ten years	30,944	31,897	29,280	30,344
Due after ten years	8,101	8,749	8,296	9,099
	59,753	62,159	57,139	59,801
Mortgage-backed securities available for sale	28,204	29,381	30,915	32,262
Total available for sale securities	$ 87,957	$ 91,540	$ 88,054	$ 92,063
Debt securities held to maturity:				
Due in one year or less	$ 2,241	$ 2,230	$ 2,241	$ 2,228
Due after one year through five years	312	316	317	322
Due after five years through ten years	511	483	516	490
Due after ten years	670	678	670	681
	3,734	3,707	3,744	3,721
Total held to maturity securities	$ 3,734	$ 3,707	$ 3,744	$ 3,721

Information regarding unrealized losses within the Company’s available for sale securities at March 31, 2013 and December 31, 2012, is summarized below. The securities are primarily U.S. government-guaranteed agency securities or municipal securities. All unrealized losses are considered temporary and related to market interest rate fluctuations.

	March 31, 2013					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 5,921	$ (78)	$ -	$ -	$ 5,921	$ (78)
States and political subdivisions	963	(10)	105	(3)	1,068	(13)
Total debt securities	$ 6,884	$ (88)	$ 105	$ (3)	$ 6,989	$ (91)
Mortgage-backed securities:						
FNMA	$ 34	$ -	$ -	$ -	$ 34	$ -
FHLMC	1,930	(7)	-	-	1,930	(7)
GNMA	-	-	-	-	-	-
CMO'S	-	-	-	-	-	-
Total mortgage-backed securities	$ 1,964	$ (7)	$ -	$ -	$ 1,964	$ (7)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 2,644	$ (46)	$ 16	$ -	$ 2,660	$ (46)
Total temporarily impaired securities	$ 11,492	$ (141)	$ 121	$ (3)	$ 11,613	$ (144)

December 31, 2012

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 3,968	$ (32)	$ -	$ -	$ 3,968	$ (32)
States and political subdivisions	1,192	(10)	-	-	1,192	(10)
Total debt securities	$ 5,160	$ (42)	$ -	$ -	$ 5,160	$ (42)
Mortgage-backed securities:						
FNMA	$ 34	$ -	$ -	$ -	$ 34	$ -
FHLMC	-	-	-	-	-	-
GNMA	-	-	-	-	-	-
CMO'S	-	-	-	-	-	-
Total mortgage-backed securities	$ 34	$ -	$ -	$ -	$ 34	$ -
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 2,660	$ (46)	$ -	$ -	$ 2,660	$ (46)
Total temporarily impaired securities	$ 7,854	$ (88)	$ -	$ -	$ 7,854	$ (88)

In regard to municipal securities, the Company’s general investment policy is that in-state securities must be rated at least Moody’s Baa (or equivalent) at the time of purchase. The Company reviews the ratings report and municipality financial statements and prepares a pre-purchase analysis report before the purchase of any municipal securities. Out-of-state issues must be rated by Moody’s at least Aa (or equivalent) at the time of purchase. The Company did not own any out-of-state municipal bonds at March 31, 2013 or December 31, 2012. Bonds rated below A are reviewed periodically to ensure their continued credit worthiness. While purchase of non-rated municipal securities is permitted under the Company’s investment policy, such purchases are limited to bonds issued by municipalities in the Company’s general market area. Those municipalities are typically customers of the Bank whose financial situation is familiar to management. The financial statements of the issuers of non-rated securities are reviewed by the Bank and a credit file of the issuers is kept on each non-rated municipal security with relevant financial information.

Although concerns have been raised in the marketplace recently about the health of municipal bonds, the Company has not experienced any significant credit troubles in this portfolio and does not believe any credit troubles are imminent with respect to its portfolio. Aside from the non-rated municipal securities to local municipalities discussed above that are considered held-to-maturity, all of the Company’s available-for-sale municipal bonds are investment-grade government obligation (“G.O.”) bonds. G.O. bonds are generally considered safer than revenue bonds because they are backed by the full faith and credit of the government while revenue bonds rely on the revenue produced by a particular project. All of the Company’s municipal bonds are issued by municipalities in New York State. To the Company’s knowledge, there has never been a default of a NY G.O. in the history of the state. The Company believes that its risk of loss on default of a G.O. municipal bond for the Company is relatively low. However, historical performance does not guarantee future performance.

Management has assessed the securities available for sale in an unrealized loss position at March 31, 2013 and December 31, 2012 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities’ amortized cost, and the financial condition of the issuer (primarily government or government-sponsored enterprises). In addition, management does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuers.

The Company had not recorded any other-than-temporary impairment (“OTTI”) charges as of March 31, 2013 and did not record any OTTI changes during 2012. The gross unrealized losses in the Company’s securities portfolio were at an immaterial level during each of those periods, amounting to less than 0.2% of the total fair value of the securities portfolio at March 31, 2013 and December 31, 2012. Nevertheless, it remains possible that there could be deterioration in the asset quality of the securities portfolio in the future. The credit worthiness of the Company’s portfolio is largely reliant on the ability of U.S. government sponsored agencies such as FHLB, Federal National Mortgage Association (“FNMA”), Government National Mortgage Association (“GNMA”), and Federal Home Loan Mortgage Corporation (“FHLMC”), and municipalities throughout New York State to meet their obligations. In addition, dysfunctional markets could materially alter the liquidity, interest rate, and pricing risk of the portfolio. The relatively stable past performance is not a guarantee for similar performance of the Company’s securities portfolio going forward.

3. FAIR VALUE MEASUREMENTS

The Company follows the provisions of ASC Topic 820, “Fair Value Measurements and Disclosures.” Those provisions relate to financial assets and liabilities carried at fair value and fair value disclosures related to financial assets and liabilities. ASC Topic 820 defines fair value and specifies a hierarchy of valuation techniques based on the nature of the inputs used to develop the fair value measures. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

There are three levels of inputs to fair value measurements:

- Level 1, meaning the use of quoted prices for identical instruments in active markets;
- Level 2, meaning the use of quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable; and
- Level 3, meaning the use of unobservable inputs.

Observable market data should be used when available.

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a recurring basis at March 31, 2013 and December 31, 2012:

	Level 1	Level 2	Level 3	Fair Value
March 31, 2013				
Securities available-for-sale:				
U.S. government agencies	$ -	$ 28,127	$ -	$ 28,127
States and political subdivisions	-	34,032	-	34,032
Mortgage-backed securities	-	29,381	-	29,381
Mortgage servicing rights	-	-	455	455
December 31, 2012				
Securities available-for-sale:				
U.S. Treasury and other U.S. government agencies	$ -	$ 28,332	$ -	$ 28,332
States and political subdivisions	-	31,469	-	31,469
Mortgage-backed securities	-	32,262	-	32,262
Mortgage servicing rights	-	-	467	467

Securities available for sale

Fair values for securities are determined using independent pricing services and market-participating brokers. The Company's independent pricing service utilizes evaluated pricing models that vary by asset class and incorporate available trade, bid and other market information for structured securities, cash flow and, when available, loan performance data. Because many fixed income securities do not trade on a daily basis, the evaluated pricing applications apply information as applicable through processes, such as benchmarking of like securities, sector groupings, and matrix pricing, to prepare evaluations. In addition, model processes, such as the Option Adjusted Spread model, are used to assess interest rate impact and develop prepayment scenarios. The models and the process take into account market convention. For each asset class, a team of evaluators gathers information from market sources and integrates relevant credit information, perceived market movements and sector news into the evaluated pricing applications and models. The company's service provider may occasionally determine that it does have not sufficient verifiable information to value a particular security. In these cases the Company will utilize valuations from another pricing service.

Management believes that it has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of securities to enable management to maintain an appropriate system of internal control. On a quarterly basis the Company reviews changes in the market value of its security portfolio. Individual changes in valuations are reviewed for consistency with general interest rate movements and any known credit concerns for specific securities. Additionally, on an annual basis the Company has its entire security portfolio priced by a second pricing service to determine consistency with another market evaluator. If, on the

Company's review or in comparing with another servicer, a material difference between pricing evaluations were to exist, the Company may submit an inquiry to the service provider regarding the data used to value a particular security. If the Company determines it has market information that would support a different valuation than the initial evaluation it can submit a challenge for a change to that security's valuation. There were no material differences in valuations noted in the first quarter of 2013 or during fiscal year 2012.

Securities available for sale are classified as Level 2 in the fair value hierarchy as the valuation provided by the third-party provider uses observable market data.

Mortgage servicing rights

Mortgage servicing rights ("MSRs") do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSRs using a third-party pricing provider. The provider determines the fair value by discounting projected net servicing cash flows of the remaining servicing portfolio. The valuation model used by the provider considers market loan prepayment predictions and other economic factors which management considers to be significant unobservable inputs. The fair value of MSRs is mostly affected by changes in mortgage interest rates since rate changes cause the loan prepayment acceleration factors to increase or decrease. All assumptions are market driven. Management has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of MSRs to enable management to maintain an appropriate system of internal control. Mortgage servicing rights are classified within Level 3 of the fair value hierarchy as the valuation is model driven and primarily based on unobservable inputs.

The following table summarizes the changes in fair value for mortgage servicing rights during the three month periods ended March 31, 2013 and 2012, respectively:

	Three months ended March 31,	
	2013	2012
Beginning balance, Dec 31	$ 467	$ 407
Losses included in earnings	(20)	(7)
Additions from loan sales	8	54
Ending balance, March 31	$ 455	$ 454

Quantitative information about the significant unobservable inputs used in the fair value measurement of MSRs at the respective dates is as follows:

	3/31/2013	3/31/2012
Servicing fees	0.25 %	0.25 %
Discount rate	10.05 %	10.09 %
Prepayment rate (CPR)	15.06 %	15.48 %

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements. The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a nonrecurring basis at March 31, 2013 and December 31, 2012:

	Level 1	Level 2	Level 3	Fair Value
March 31, 2013				
Impaired loans	$ -	-	13,103	$ 13,103
December 31, 2012				
Impaired loans	$ -	-	12,303	$ 12,303

Impaired loans

The Company evaluates and values impaired loans at the time the loan is identified as impaired, and the fair values of such loans are estimated using Level 3 inputs in the fair value hierarchy. Each loan's collateral has a unique appraisal and management's discount of the value is based on factors unique to each impaired loan. The significant unobservable input in determining the fair value is management's subjective discount on appraisals of the collateral securing the loan, which ranges from 10%-50%. Collateral may consist of real estate and/or business assets including equipment, inventory and/or accounts receivable and the value of these assets is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, estimated costs to sell, and/or management's expertise and knowledge of the client and the client's business.

The Company has an appraisal policy in which appraisals are obtained upon a commercial loan being downgraded on the Company internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired commercial loans are either graded a 6 or 7 on the internal loan rating scale. For consumer loans, the Company obtains appraisals when a loan becomes 90 days past due or is determined to be impaired, whichever occurs first. Subsequent to the downgrade or reaching 90 days past due, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change

in the condition of the collateral, or feedback from local appraisers. Impaired loans had a gross value of $14.2 million, with a valuation allowance of $1.1 million, at March 31, 2013, compared to a gross value for impaired loans of $13.6 million, with a valuation allowance of $1.3 million, at December 31, 2012.

FAIR VALUE OF FINANCIAL INSTRUMENTS

At March 31, 2013 and December 31, 2012, the estimated fair values of the Company's financial instruments, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis, were as follows:

	March 31, 2013		December 31, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
Financial assets:				
Level 1:				
Cash and cash equivalents	$ 100,598	$ 100,598	$ 90,477	$ 90,477
Level 2:				
Available for sale securities	91,540	91,540	92,063	92,063
FHLB and FRB stock	2,946	2,946	3,249	3,249
Level 3:				
Held to maturity securities	3,734	3,707	3,744	3,721
Loans and leases, net	577,932	612,984	573,163	607,916
Mortgage servicing rights	455	455	467	467
Financial liabilities:				
Level 1:				
Demand deposits	$ 123,084	$ 123,084	$ 123,405	$ 123,405
NOW deposits	73,016	73,016	65,753	65,753
Regular savings deposits	391,739	391,739	380,924	380,924
Junior subordinated debentures	11,330	11,330	11,330	11,330
Commitments to extend credit	90	90	49	49
Securities sold under agreement to repurchase	13,784	13,784	12,111	12,111
Level 2:				
Other borrowed funds	12,000	12,377	19,000	19,503
Level 3:				

Time deposits	110,461	113,347	108,910	111,883

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practical to estimate that value.

Cash and Cash Equivalents. For these short-term instruments, the carrying amount is a reasonable estimate of fair value. "Cash and Cash Equivalents" includes interest-bearing deposits at other banks.

FHLB and FRB stock. The carrying value of FHLB and FRB stock approximate fair value.

Securities held to maturity. The Company holds certain municipal bonds as held-to-maturity. These bonds are generally small in dollar amount and are issued only by certain local municipalities within the Company's market area. The original terms are negotiated directly and on an individual basis consistent with our loan and credit guidelines. These bonds are not traded on the open market and management intends to hold the bonds to maturity. The fair value of held-to-maturity securities is estimated by discounting the future cash flows using the current rates at which similar agreements would be made with municipalities with similar credit ratings and for the same remaining maturities.

Loans and Leases, net. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities, net of the appropriate portion of the allowance for loan losses. For variable rate loans, the carrying amount is a reasonable estimate of fair value. This fair value calculation is not necessarily indicative of the exit price, as defined in ASC 820.

Deposits. The fair value of demand deposits, NOW accounts, muni-vest accounts and regular savings accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated using the rates currently offered for deposits of similar remaining maturities.

Junior Subordinated Debentures. The carrying amount of Junior Subordinated Debentures is a reasonable estimate of fair value due to the fact that they bear a floating interest rate that adjusts on a quarterly basis.

Commitments to extend credit and standby letters of credit. As described in Note 8 - “Contingent Liabilities and Commitments” to these Unaudited Consolidated Financial Statements, the Company was a party to financial instruments with off-balance sheet risk at March 31, 2013 and December 31, 2012. Such financial instruments consist of commitments to extend permanent financing and letters of credit. If the options are exercised by the prospective borrowers, these financial instruments will become interest-earning assets of the Company. If the options expire, the Company retains any fees paid by the counterparty in order to obtain the commitment or guarantee. The fees collected for these commitments are recorded as “unearned commitment fees” in Other Liabilities. The carrying value approximates the fair value.

Securities Sold Under Agreement to Repurchase. The fair value of the securities sold under agreement to repurchase approximates its carrying value.

Other Borrowed Funds. The fair value of the short-term portion of other borrowed funds approximates its carrying value. The fair value of the long-term portion of other borrowed funds is estimated using a discounted cash flow analysis based on the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

4. LOANS, LEASES, AND THE ALLOWANCE FOR LOAN AND LEASE LOSSES