

EMCLAIRE FINANCIAL CORP  
Form 10-Q  
August 12, 2013

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 2013**

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: **001-34527**

**EMCLAIRE FINANCIAL CORP**

(Exact name of registrant as specified in its charter)

Pennsylvania

(State or other jurisdiction of incorporation or organization)

25-1606091

(IRS Employer Identification No.)

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612 Main Street, Emlenton, Pennsylvania 16373  
(Address of principal executive offices) (Zip Code)

**(724) 867-2311**  
(Registrant's telephone number)

(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  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  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 as defined in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  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

The number of shares outstanding of the Registrant's common stock was 1,763,158 at August 12, 2013.

**EMCLAIRE FINANCIAL CORP**

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**PART I - FINANCIAL INFORMATION****Item 1. Interim Financial Statements**

Emclaire Financial Corp

Consolidated Balance Sheets

As of June 30, 2013 (Unaudited) and December 31, 2012

(Dollar amounts in thousands, except per share data)

	June 30, 2013	December 31, 2012
Assets		
Cash and due from banks	\$1,992	\$ 2,468
Interest earning deposits with banks	9,413	17,956
Cash and cash equivalents	11,405	20,424
Securities available for sale	146,281	120,206
Loans receivable, net of allowance for loan losses of \$4,670 and \$5,350	334,291	333,801
Federal bank stocks, at cost	3,440	2,885
Bank-owned life insurance	10,236	10,072
Accrued interest receivable	1,582	1,533
Premises and equipment, net	11,095	9,180
Goodwill	3,664	3,664
Core deposit intangible, net	1,090	1,235
Prepaid expenses and other assets	6,540	6,014
Total Assets	\$529,624	\$ 509,014
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits:		
Non-interest bearing	\$106,433	\$ 98,559
Interest bearing	343,064	333,900
Total deposits	449,497	432,459
Short-term borrowed funds	5,500	-
Long-term borrowed funds	20,000	20,000
Accrued interest payable	377	442
Accrued expenses and other liabilities	4,637	4,388

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Total Liabilities	480,011	457,289
Commitments and Contingent Liabilities	-	-
Stockholders' Equity:		
Preferred stock, \$1.00 par value, 3,000,000 shares authorized; Series B, non-cumulative preferred stock, \$10,000 liquidation value, 10,000 shares issued and outstanding, respectively	10,000	10,000
Common stock, \$1.25 par value, 12,000,000 shares authorized; 1,864,175 and 1,861,425 shares issued; 1,762,158 and 1,759,408 shares outstanding	2,330	2,327
Additional paid-in capital	19,385	19,270
Treasury stock, at cost; 102,017 shares	(2,114 )	(2,114 )
Retained earnings	22,514	21,672
Accumulated other comprehensive income (loss)	(2,502 )	570
Total Stockholders' Equity	49,613	51,725
Total Liabilities and Stockholders' Equity	\$529,624	\$ 509,014

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

## Consolidated Statements of Net Income (Unaudited)

For the three and six months ended June 30, 2013 and 2012

(Dollar amounts in thousands, except per share data)

	For the three months ended June 30,		For the six months ended June 30,	
	2013	2012	2013	2012
Interest and dividend income:				
Loans receivable, including fees	\$4,098	\$4,288	\$8,297	\$8,600
Securities:				
Taxable	470	578	887	1,147
Exempt from federal income tax	295	288	562	586
Federal bank stocks	17	15	35	31
Interest earning deposits with banks	18	29	31	50
Total interest and dividend income	4,898	5,198	9,812	10,414
Interest expense:				
Deposits	805	1,027	1,643	2,096
Borrowed funds	194	235	392	470
Total interest expense	999	1,262	2,035	2,566
Net interest income	3,899	3,936	7,777	7,848
Provision for loan losses	153	115	295	228
Net interest income after provision for loan losses	3,746	3,821	7,482	7,620
Noninterest income:				
Fees and service charges	428	375	826	731
Commissions on financial services	76	139	139	225
Title premiums	27	16	49	33
Net gain on sales of available for sale securities	99	538	184	962
Earnings on bank-owned life insurance	96	62	192	124
Other	305	291	571	565
Total noninterest income	1,031	1,421	1,961	2,640
Noninterest expense:				
Compensation and employee benefits	1,932	1,867	3,837	3,810
Premises and equipment	527	500	1,069	1,019
Intangible asset amortization	73	93	145	186
Professional fees	178	175	355	375

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Federal deposit insurance	102	94	208	190
Other	820	835	1,593	1,618
Total noninterest expense	3,632	3,564	7,207	7,198
Income before provision for income taxes	1,145	1,678	2,236	3,062
Provision for income taxes	206	422	439	768
Net income	939	1,256	1,797	2,294
Preferred stock dividends	125	125	250	250
Net income available to common stockholders	\$814	\$1,131	\$1,547	\$2,044
Basic earnings per common share	\$0.46	\$0.65	\$0.88	\$1.17
Diluted earnings per common share	0.46	0.65	0.87	1.17
Average common shares outstanding	1,762,158	1,751,908	1,761,546	1,751,908

See accompanying notes to consolidated financial statements.



**Emclaire Financial Corp**

## Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

For the three and six months ended June 30, 2013 and 2012

(Dollar amounts in thousands)

	For the three months ended June 30, 2013		For the six months ended June 30, 2012	
Net income	\$939	\$1,256	\$1,797	\$2,294
Other comprehensive income (loss)				
Unrealized gains (losses) on securities:				
Unrealized holding gain (loss) arising during the period	(4,110)	645	(4,471)	444
Reclassification adjustment for gains included in net income	(99 )	(538 )	(184 )	(962 )
	(4,209)	107	(4,655)	(518 )
Tax effect	1,431	(37 )	1,583	176
Net of tax	(2,778)	70	(3,072)	(342 )
Comprehensive income (loss)	\$(1,839)	\$1,326	\$(1,275)	\$1,952

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**

## Condensed Consolidated Statements of Cash Flows (Unaudited)

For the six months ended June 30, 2013 and 2012

(Dollar amounts in thousands)

	For the six months ended	
	June 30, 2013	2012
Cash flows from operating activities		
Net income	\$ 1,797	\$ 2,294
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	336	347
Provision for loan losses	295	228
Amortization of premiums, net	90	98
Amortization of intangible assets and mortgage servicing rights	145	189
Realized gains on sales of available for sale securities, net	(184 )	(962 )
Net (gains) losses on foreclosed real estate	(12 )	16
Restricted stock and stock option compensation	98	60
Increase in bank-owned life insurance, net	(164 )	(107 )
Increase in accrued interest receivable	(49 )	(53 )
(Increase) decrease in prepaid expenses and other assets	1,111	(293 )

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Decrease in accrued interest payable	(65	)	(15	)
Increase in accrued expenses and other liabilities	250		130	
Net cash provided by operating activities	3,648		1,932	
Cash flows from investing activities				
Loan originations and principal collections, net	(1,055	)	(14,033	)
Available for sale securities:				
Sales	3,314		5,596	
Maturities, repayments and calls	26,304		41,075	
Purchases	(60,116	)	(82,278	)
(Purchase) redemption of federal bank stocks	(555	)	261	
Proceeds from the sale of foreclosed real estate	70		248	
Write-down of foreclosed real estate	19		-	
Purchases of premises and equipment	(2,251	)	(225	)
Net cash used in investing activities	(34,270	)	(49,356	)
Cash flows from financing activities				
Net increase in deposits	17,038		46,942	
Net change in short-term borrowings	5,500		-	
Proceeds from exercise of stock options, including tax benefit	20		-	
Dividends paid	(955	)	(880	)
Net cash provided by financing activities	21,603		46,062	
Decrease in cash and cash equivalents	(9,019	)	(1,362	)
Cash and cash equivalents at beginning of period	20,424		28,193	
Cash and cash equivalents at end of	\$ 11,405		\$ 26,831	

period

Supplemental  
information:

Interest paid	\$	2,100	\$	2,581
Income taxes paid		140		1,020

Supplemental noncash  
disclosure:

Transfers from loans to foreclosed real estate		92		264
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See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

## Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

For the three and six months ended June 30, 2013 and 2012

(Dollar amounts in thousands, except per share data)

	For the three months ended June 30,		For the six months ended June 30,	
	2013	2012	2013	2012
Balance at beginning of period	\$51,866	\$50,945	\$51,725	\$50,730
Net income	939	1,256	1,797	2,294
Other comprehensive income (loss)	(2,778 )	70	(3,072 )	(342 )
Stock compensation expense	63	31	98	60
Dividends declared on preferred stock	(125 )	(125 )	(250 )	(250 )
Dividends declared on common stock	(352 )	(315 )	(705 )	(630 )
Exercise of stock options, including tax benefit	-	-	20	-
Balance at end of period	\$49,613	\$51,862	\$49,613	\$51,862
Common cash dividend per share	\$0.20	\$0.18	\$0.40	\$0.36

See accompanying notes to consolidated financial statements.

## **Emclair Financial Corp**

Notes to Consolidated Financial Statements (Unaudited)

### **1. Nature of Operations and Basis of Presentation**

Emclair Financial Corp (the Corporation) is a Pennsylvania corporation and the holding company of The Farmers National Bank of Emlenton (the Bank) and Emclair Settlement Services, LLC (the Title Company). The Corporation provides a variety of financial services to individuals and businesses through its offices in Western Pennsylvania. Its primary deposit products are checking, savings and term certificate accounts and its primary lending products are residential and commercial mortgages, commercial business loans and consumer loans.

The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries, the Bank and the Title Company. All significant intercompany transactions and balances have been eliminated in preparing the consolidated financial statements.

The accompanying unaudited consolidated financial statements for the interim periods include all adjustments, consisting of normal recurring accruals, which are necessary, in the opinion of management, to fairly reflect the Corporation's consolidated financial position and results of operations. Additionally, these consolidated financial statements for the interim periods have been prepared in accordance with instructions for the Securities and Exchange Commission's (SEC's) Form 10-Q and Article 10 of Regulation S-X and therefore do not include all information or footnotes necessary for a complete presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America (GAAP). For further information, refer to the audited consolidated financial statements and footnotes thereto for the year ended December 31, 2012, as contained in the Corporation's 2012 Annual Report on Form 10-K filed with the SEC.

The balance sheet at December 31, 2012 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by GAAP for complete financial statements.

The preparation of financial statements, in conformity with GAAP, requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, goodwill, real estate owned, the valuation of deferred tax assets and other-than-temporary impairment charges on securities. The results of operations for interim quarterly or year-to-date periods are not necessarily indicative of the results that may be expected for the entire year or any other period. Certain amounts previously reported may have been reclassified to conform to the current year's financial statement presentation.



## **2. Participation in the Small Business Lending Fund (SBLF) of the U.S. Treasury Department (U.S. Treasury)**

On August 18, 2011, the Corporation entered into a Securities Purchase Agreement (the Agreement) with the U.S. Treasury Department, pursuant to which the Corporation issued and sold to the U.S. Treasury 10,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Series B Preferred Stock), having a liquidation preference of \$1,000 per share, for aggregate proceeds of \$10.0 million. The issuance was pursuant to the U.S. Treasury's SBLF program, a \$30.0 billion fund established under the Small Business Jobs Act of 2010, which encouraged lending to small businesses by providing capital to qualified community banks with assets less than \$10.0 billion. The Series B Preferred Stock is entitled to receive non-cumulative dividends payable quarterly on each January 1, April 1, July 1 and October 1, beginning October 1, 2011. The dividend rate, which is calculated on the aggregate liquidation amount, was initially set at 5% per annum based upon the current level of Qualified Small Business Lending (QSBL) by the Bank. The dividend rate for future periods is set based upon the percentage change in qualified lending between each dividend period and the baseline QSBL level established at the time the Agreement was entered into. Such dividend rate may vary from 1% per annum to 5% per annum for the second through tenth dividend periods, and will be fixed at a rate of 1% per annum to 7% per annum for the eleventh through the eighteenth dividend periods. If the Series B Preferred Stock remains outstanding for more than four-and-one-half years, the dividend rate will be fixed at 9%. Prior to that time, in general, the dividend rate decreases as the level of the Bank's QSBL increases. The dividend rate was 5.0% for the quarters ended June 30, 2013 and 2012. Such dividends are not cumulative, but the Corporation may only declare and pay dividends on its common stock (or any other equity securities junior to the Series B Preferred Stock) if it has declared and paid dividends for the current dividend period on the Series B Preferred Stock, and will be subject to other restrictions on its ability to repurchase or redeem other securities.

As more completely described in the Certificate of Designation, holders of the Series B Preferred Stock have the right to vote as a separate class on certain matters relating to the rights of holders of Series B Preferred Stock and on certain corporate transactions. Except with respect to such matters, the Series B Preferred Stock does not have voting rights.

The Corporation may redeem the shares of Series B Preferred Stock, in whole or in part, at any time at a redemption price equal to the sum of the liquidation amount and the per-share amount of any unpaid dividends for the then-current period, subject to any required prior approval by the Corporation's primary federal banking regulator. If paid in part, payments are required to be at least 25% of the original proceeds.

## **3. Earnings per Common Share**

Basic earnings per common share (EPS) excludes dilution and is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS includes the dilutive effect of additional potential common shares for assumed issuance of restricted stock and shares issued under stock options.





**3. Earnings per Common Share (continued)**

The factors used in the Corporation's earnings per common share computation follow:

(Dollar amounts in thousands, except for per share amounts)	For the three months ended		For the six months ended	
	June 30, 2013	2012	June 30, 2013	2012
Earnings per common share - basic				
Net income	\$939	\$1,256	\$1,797	\$2,294
Less: Preferred stock dividends	125	125	250	250
Net income available to common stockholders	\$814	\$1,131	\$1,547	\$2,044
Average common shares outstanding	1,762,158	1,751,908	1,761,546	1,751,908
Basic earnings per common share	\$0.46	\$0.65	\$0.88	\$1.17
Earnings per common share - diluted				
Net income available to common stockholders	\$814	\$1,131	\$1,547	\$2,044
Average common shares outstanding	1,762,158	1,751,908	1,761,546	1,751,908
Add: Dilutive effects of assumed exercises of restricted stock and stock options	14,223	-	13,350	-
Average shares and dilutive potential common shares	1,776,381	1,751,908	1,774,896	1,751,908
Diluted earnings per common share	\$0.46	\$0.65	\$0.87	\$1.17
Stock options and restricted stock awards not considered in computing diluted earnings per share because they were antidilutive	67,000	84,000	67,000	84,000

**4. Securities**

The following table summarizes the Corporation's securities as of June 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)	Amortized	Gross Unrealized	Gross Unrealized	Fair
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	Cost	Gains	Losses	Value
Available for sale:				
June 30, 2013:				
U.S. Treasury and federal agency	\$ 6,958	\$ -	\$ (208 )	\$ 6,750
U.S. government sponsored entities and agencies	27,635	-	(723 )	26,912
Mortgage-backed securities: residential	15,011	590	-	15,601
Collateralized mortgage obligations: residential	45,807	39	(1,144 )	44,702
State and political subdivisions	45,606	1,126	(841 )	45,891
Corporate debt securities	3,979	26	(19 )	3,986
Equity securities	2,356	103	(20 )	2,439
	\$ 147,352	\$ 1,884	\$ (2,955 )	\$ 146,281
December 31, 2012:				
U.S. Treasury and federal agency	\$ 3,959	\$ 8	\$ -	\$ 3,967
U.S. government sponsored entities and agencies	28,030	132	-	28,162
Mortgage-backed securities: residential	21,137	1,587	-	22,724
Collateralized mortgage obligations: residential	22,508	47	(80 )	22,475
State and political subdivisions	34,904	1,862	(1 )	36,765
Corporate debt securities	3,728	34	(1 )	3,761
Equity securities	2,356	4	(8 )	2,352
	\$ 116,622	\$ 3,674	\$ (90 )	\$ 120,206

**4. Securities (continued)**

The following table summarizes scheduled maturities of the Corporation's debt securities as of June 30, 2013. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities and collateralized mortgage obligations are not due at a single maturity and are shown separately.

(Dollar amounts in thousands)	Available for sale Amortized Fair	
	Cost	Value
Due in one year or less	\$2,551	\$2,579
Due after one year through five years	29,789	29,710
Due after five through ten years	46,400	46,117
Due after ten years	5,438	5,133
Mortgage-backed securities: residential	15,011	15,601
Collateralized mortgage obligations: residential	45,807	44,702
	\$144,996	\$143,842

Information pertaining to securities with gross unrealized losses at June 30, 2013 and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

(Dollar amounts in thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
June 30, 2013:						
U.S. Treasury and federal agency	\$6,458	\$ (208 )	\$ -	\$ -	\$6,458	\$ (208 )
U.S. government sponsored entities and agencies	27,635	(723 )	-	-	27,635	(723 )
Collateralized mortgage obligations: residential	36,432	(1,144 )	-	-	36,432	(1,144 )
State and political subdivisions	16,281	(841 )	-	-	16,281	(841 )
Corporate debt securities	1,006	(19 )	-	-	1,006	(19 )
Equity securities	950	(20 )	-	-	950	(20 )
	\$88,762	\$ (2,955 )	\$ -	\$ -	\$88,762	\$ (2,955 )
December 31, 2012:						
Collateralized mortgage obligations: residential	\$10,698	\$ (80 )	\$ -	\$ -	\$10,698	\$ (80 )
State and political subdivisions	521	(1 )	-	-	521	(1 )
Corporate debt securities	500	(1 )	-	-	500	(1 )
Equity securities	493	(8 )	-	-	493	(8 )

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\$12,212 \$ (90 ) \$ - \$ - \$12,212 \$ (90 )

Gains on sales of available for sale securities for the three and six month periods ended June 30 were as follows:

(Dollar amounts in thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2013	2012	2013	2012
Proceeds	\$1,539	\$4,484	\$3,314	\$5,596
Gains	99	538	184	962
Tax provision related to gains	34	183	63	327

**4. Securities (continued)**

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic, market or other conditions warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the Corporation has the intent 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. If the Corporation intends to sell an impaired security, or if it is more likely than not the Corporation will be required to sell the security before its anticipated recovery, the Corporation records an other-than-temporary loss in an amount equal to the entire difference between fair value and amortized cost. Otherwise, only the credit portion of the estimated loss on debt securities is recognized in earnings, with the other portion of the loss recognized in other comprehensive income. For equity securities determined to be other-than-temporarily impaired, the entire amount of impairment is recognized through earnings.

There was one equity security in an unrealized loss position as of June 30, 2013. This security has been in an unrealized loss position for less than 12 months and was valued at 98% of its cost basis as of June 30, 2013. Equity securities owned by the Corporation consist of common stock of various financial service providers. The investment securities are in an unrealized loss position as a result of recent market volatility. The Corporation does not invest in these securities with the intent to sell them for a profit in the near term. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability and capital adequacy and all other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost as the sector improves. Based on that evaluation, and given that the Corporation's current intention is not to sell any impaired security and it is more likely than not it will not be required to sell this security before the recovery of its amortized cost basis, the Corporation does not consider the equity security with an unrealized loss as of June 30, 2013 to be other-than-temporarily impaired.

There were 123 debt securities in an unrealized loss position as of June 30, 2013, all of which were in an unrealized loss position for less than 12 months. Of these securities, 12 were U.S. Treasury securities, 19 were U.S. agency securities, 24 were collateralized mortgage obligations, 64 were state and political subdivision securities and 4 were corporate debt securities. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the failure to collect contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the debt securities with unrealized losses as of June 30, 2013 to be other-than-temporarily impaired.

## 5. Loans Receivable and Related Allowance for Loan Losses

The Corporation's loans receivable as of the respective dates are summarized as follows:

(Dollar amounts in thousands)	June 30, 2013	December 31, 2012
Mortgage loans on real estate:		
Residential first mortgages	\$93,338	\$ 97,246
Home equity loans and lines of credit	86,774	85,615
Commercial real estate	97,168	98,823
	277,280	281,684
Other loans:		
Commercial business	51,337	45,581
Consumer	10,344	11,886
	61,681	57,467
Total loans, gross	338,961	339,151
Less allowance for loan losses	4,670	5,350
Total loans, net	\$334,291	\$ 333,801

## 5. Loans Receivable and Related Allowance for Loan Losses (continued)

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of June 30, 2013:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the three months		Cash Basis Interest Recognized in Period
	As of June 30, 2013		Related Allowance	Average	Interest Income	
	Unpaid Principal Balance	Recorded Investment			Recorded Investment	Recognized in Period
Residential first mortgages	\$81	\$ 81	\$ 20	\$ 40	\$ 2	\$ 2
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	3,665	2,724	214	3,364	5	5
Commercial business	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	\$3,746	\$ 2,805	\$ 234	\$ 3,404	\$ 7	\$ 7

  

	For the six months			Cash Basis Interest Recognized in Period
	ended June 30, 2013		Average	
	Average	Interest Income		Recognized
	Recorded	Recognized	Investment	in Period
	Investment	in Period		
Residential first mortgages	\$27	\$ 2	\$ 2	
Home equity and lines of credit	-	-	-	
Commercial real estate	3,599	9	9	
Commercial business	-	-	-	
Consumer	-	-	-	
Total	\$3,626	\$ 11	\$ 11	

### Impaired Loans with No Specific Allowance

	As of June 30, 2013		For the three months		Cash Basis Interest Recognized in Period
	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	



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Residential first mortgages	\$ -	\$ -	\$ -	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-
Commercial real estate	1,061	662	563	2	2
Commercial business	356	356	360	-	-
Consumer	1,348	1,348	1,469	-	-
Total	\$ 2,765	\$ 2,366	\$ 2,392	\$ 2	\$ 2

For the six months  
ended June 30, 2013

	Average Recorded Investment in Period	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	\$ -	\$ -	\$ -
Home equity and lines of credit	-	-	-
Commercial real estate	544	3	3
Commercial business	363	-	-
Consumer	1,529	-	-
Total	\$ 2,436	\$ 3	\$ 3

## 5. Loans Receivable and Related Allowance for Loan Losses (continued)

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of December 31, 2012:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance			For the year ended		Cash Basis Interest Recognized in Period
	As of December 31, 2012		Related Allowance	December 31, 2012		
	Unpaid Principal Balance	Recorded Investment			Average Recorded Investment	Interest Recognized in Period
Residential first mortgages	\$-	\$ -	\$ -	\$-	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	4,242	4,068	1,448	2,075	186	16
Commercial business	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	\$4,242	\$ 4,068	\$ 1,448	\$2,075	\$ 186	\$ 16

  

	Impaired Loans with No Specific Allowance			For the year ended		Cash Basis Interest Recognized in Period
	As of December 31, 2012		Average Recorded Investment	December 31, 2012		
	Unpaid Principal Balance	Recorded Investment			Interest Recognized in Period	
Residential first mortgages	\$-	\$ -	\$-	\$ -	\$ -	\$ -
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	730	505	690	12	12	12
Commercial business	394	369	368	5	5	5
Consumer	1,650	1,650	1,774	-	-	-
Total	\$2,774	\$ 2,524	\$2,832	\$ 17	\$ 17	\$ 17

Unpaid principal balance includes any loans that have been partially charged off but not forgiven. Accrued interest is not included in the recorded investment in loans based on the amounts not being material.

**Troubled debt restructurings (TDR).** The Corporation has certain loans that have been modified in order to maximize collection of loan balances. If, for economic or legal reasons related to the customer's financial difficulties,

management grants a concession compared to the original terms and conditions of the loan that it would not have otherwise considered, the modified loan is classified as a TDR. Concessions related to TDRs generally do not include forgiveness of principal balances. The Corporation generally does not extend additional credit to borrowers with loans classified as TDRs.

At June 30, 2013 and December 31, 2012, the Corporation had \$2.1 million and \$2.3 million, respectively, of loans classified as TDRs, which are included in impaired loans above. At June 30, 2013 and December 31, 2012, the Corporation had \$55,000 and \$36,000, respectively, of the allowance for loan losses allocated to these specific loans. At June 30, 2012, the Corporation had \$796,000 of loans classified as TDRs with \$36,000 of the allowance for loan losses allocated to these specific loans.

During the six month period ended June 30, 2013, the Corporation modified a residential mortgage loan with a pre- and post-modification recorded investment of \$83,000 as a TDR due to financial difficulties experienced by the borrower. The modification included a reduction in the interest rate from 6.75% to 4.00% and a 65 month extension of the original term. At June 30, 2013, the Corporation had \$20,000 of the allowance for loan losses allocated to this specific loan. During the six month period ended June 30, 2012, the Corporation did not modify any additional loans as TDRs.

**5. Loans Receivable and Related Allowance for Loan Losses (continued)**

During the six month periods ended June 30, 2013 and 2012, the Corporation did not have any loans which were modified as TDRs for which there was a payment default within twelve months following the modification.

**Credit Quality Indicators.** Management categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors.

Commercial real estate and commercial business loans not identified as impaired are evaluated as risk rated pools of loans utilizing a risk rating practice that is supported by a quarterly special asset review. In this review process, strengths and weaknesses are identified, evaluated and documented for each criticized and classified loan and borrower, strategic action plans are developed, risk ratings are confirmed and the loan's performance status is reviewed.

Management has determined certain portions of the loan portfolio to be homogeneous in nature and assigns like reserve factors for the following loan pool types: residential real estate, home equity loans and lines of credit, and consumer installment and personal lines of credit.

The reserve allocation for risk rated loan pools is developed by applying the following factors:

**Historic:** Management utilizes a computer model to develop the historical net charge-off experience which is used to formulate the assumptions employed in the migration analysis applied to estimate future losses in the portfolio. Outstanding balance and charge-off information are input into the model and historical loss migration rate assumptions are developed to apply to pass, special mention, substandard and doubtful risk rated loans. A twelve-quarter rolling weighted-average is utilized to anticipate probable incurred losses in the portfolios.

**Qualitative:** Qualitative adjustment factors for pass, special mention, substandard and doubtful ratings are developed and applied to risk rated loans to allow for: quality of lending policies and procedures; national and local economic and business conditions; changes in the nature and volume of the portfolio; experiences, ability and depth of lending management; changes in trends, volume and severity of past due, nonaccrual and classified loans and loss and recovery trends; quality of loan review systems; concentrations of credit and other external factors.

Management uses the following definitions for risk ratings:

Pass: Loans classified as pass typically exhibit good payment performance and have underlying borrowers with acceptable financial trends where repayment capacity is evident. These borrowers typically would have a sufficient cash flow that would allow them to weather an economic downturn and the value of any underlying collateral could withstand a moderate degree of depreciation due to economic conditions.

Special Mention: Loans classified as special mention are characterized by potential weaknesses that could jeopardize repayment as contractually agreed. These loans may exhibit adverse trends such as increasing leverage, shrinking profit margins and/or deteriorating cash flows. These borrowers would inherently be more vulnerable to the application of economic pressures.

Substandard: Loans classified as substandard exhibit weaknesses that are well-defined to the point that repayment is jeopardized. Typically, the Corporation is no longer adequately protected by both the apparent net worth and repayment capacity of the borrower.

Doubtful: Loans classified as doubtful have advanced to the point that collection or liquidation in full, on the basis of currently ascertainable facts, conditions and value, is highly questionable or improbable.

### 5. Loans Receivable and Related Allowance for Loan Losses (continued)

The following table presents the classes of the loan portfolio summarized by the aggregate pass and the criticized categories of special mention, substandard and doubtful within the Corporation's internal risk rating system as of June 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)

	Not Rated	Pass	Special Mention	Substandard	Doubtful	Total
June 30, 2013:						
Residential first mortgages	\$ 93,068	\$-	\$ -	\$ 270	\$ -	\$ 93,338
Home equity and lines of credit	86,570	-	-	204	-	86,774
Commercial real estate	-	89,049	508	7,611	-	97,168
Commercial business	-	48,076	723	2,538	-	51,337
Consumer	8,996	-	-	1,348	-	10,344
Total	\$ 188,634	\$ 137,125	\$ 1,231	\$ 11,971	\$ -	\$ 338,961
December 31, 2012:						
Residential first mortgages	\$ 96,713	\$-	\$ -	\$ 533	\$ -	\$ 97,246
Home equity and lines of credit	85,443	-	-	172	-	85,615
Commercial real estate	-	88,944	1,658	6,870	1,351	98,823
Commercial business	-	42,417	2,157	1,007	-	45,581
Consumer	10,236	-	-	1,650	-	11,886
Total	\$ 192,392	\$ 131,361	\$ 3,815	\$ 10,232	\$ 1,351	\$ 339,151

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonperforming loans as of June 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)

	Performing Accruing Loans Not Past Due	Accruing 30-59 Days Past Due	Accruing 60-89 Days Past Due	Nonperforming Accruing 90 Days + Past Due	Nonaccrual	Total Loans
June 30, 2013:						
Residential first mortgages	\$ 90,251	\$ 2,530	\$ 197	\$ 41	\$ 319	\$ 93,338

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Home equity and lines of credit	85,968	530	73	61	142	86,774
Commercial real estate	93,974	132	-	-	3,062	97,168
Commercial business	50,618	363	-	-	356	51,337
Consumer	8,990	4	2	-	1,348	10,344
Total loans	\$ 329,801	\$ 3,559	\$ 272	\$ 102	\$ 5,227	\$ 338,961

December 31, 2012:

Residential first mortgages	\$95,001	\$ 1,272	\$ 440	\$-	\$ 533	\$97,246
Home equity and lines of credit	84,592	669	157	-	197	85,615
Commercial real estate	94,485	50	49	21	4,218	98,823
Commercial business	44,915	297	-	-	369	45,581
Consumer	10,172	41	23	-	1,650	11,886
Total loans	\$ 329,165	\$ 2,329	\$ 669	\$ 21	\$ 6,967	\$ 339,151

## 5. Loans Receivable and Related Allowance for Loan Losses (continued)

The following table presents the Corporation's nonaccrual loans by aging category as of June 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)

	Not Past Due	30-59 Days Past Due	60-89 Days Past Due	90 Days + Past Due	Total Loans
June 30, 2013:					
Residential first mortgages	\$ 89	\$ -	\$ -	\$ 230	\$319
Home equity and lines of credit	-	-	-	142	142
Commercial real estate	440	2,283	-	339	3,062
Commercial business	70	-	-	286	356
Consumer	1,348	-	-	-	1,348
Total loans	\$ 1,947	\$ 2,283	\$ -	\$ 997	\$5,227
December 31, 2012:					
Residential first mortgages	\$ -	\$ -	\$ -	\$ 533	\$533
Home equity and lines of credit	-	25	-	172	197
Commercial real estate	469	3,386	10	353	4,218
Commercial business	78	-	-	291	369
Consumer	1,650	-	-	-	1,650
Total loans	\$ 2,197	\$ 3,411	\$ 10	\$ 1,349	\$6,967

An allowance for loan losses (ALL) is maintained to absorb probable incurred losses from the loan portfolio. The ALL is based on management's continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated loss experience and the amount of nonperforming loans.

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



## 5. Loans Receivable and Related Allowance for Loan Losses (continued)

The following table details activity in the ALL and the recorded investment by portfolio segment based on impairment method:

(Dollar amounts in thousands)

	Residential Mortgages	Home Equity & Lines of Credit	Commercial Real Estate	Commercial Business	Consumer	Total
Three months ended June 30, 2013:						
Allowance for loan losses:						
Beginning Balance	\$ 807	\$ 727	\$ 3,189	\$ 702	\$ 63	\$5,488
Charge-offs	(12 )	-	(941 )	-	(25 )	(978 )
Recoveries	-	-	2	-	5	7
Provision	(23 )	(106 )	297	(25 )	10	153
Ending Balance	\$ 772	\$ 621	\$ 2,547	\$ 677	\$ 53	\$4,670
Six months ended June 30, 2013:						
Allowance for loan losses:						
Beginning Balance	\$ 828	\$ 730	\$ 3,090	\$ 636	\$ 66	\$5,350
Charge-offs	(17 )	-	(941 )	-	(56 )	(1,014 )
Recoveries	1	-	4	-	34	39
Provision	(40 )	(109 )	394	41	9	295
Ending Balance	\$ 772	\$ 621	\$ 2,547	\$ 677	\$ 53	\$4,670
At June 30, 2013:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	20	-	214	-	-	234
Collectively evaluated for impairment	752	621	2,333	677	53	4,436
Total loans:						
Individually evaluated for impairment	81	-	3,386	356	1,348	5,171
Collectively evaluated for impairment	93,257	86,774	93,782	50,981	8,996	333,790
At December 31, 2012:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	-	-	1,448	-	-	1,448
Collectively evaluated for impairment	828	730	1,642	636	66	3,902
Total loans:						
Individually evaluated for impairment	-	-	4,573	369	1,650	6,592
Collectively evaluated for impairment	97,246	85,615	94,250	45,212	10,236	332,559

Three months ended June 30, 2012:

Allowance for loan losses:

Beginning Balance	\$ 856	\$ 413	\$ 1,723	\$ 586	\$ 64	\$3,642
Charge-offs	(15 )	(4 )	(36 )	(10 )	(11 )	(76 )
Recoveries	7	20	2	-	5	34
Provision	4	39	146	(80 )	6	115
Ending Balance	\$ 852	\$ 468	\$ 1,835	\$ 496	\$ 64	\$3,715

Six months ended June 30, 2012:

Allowance for loan losses:

Beginning Balance	\$ 832	\$ 320	\$ 1,737	\$ 590	\$ 57	\$3,536
Charge-offs	(65 )	(40 )	(36 )	(10 )	(37 )	(188 )
Recoveries	83	27	4	15	10	139
Provision	2	161	130	(99 )	34	228
Ending Balance	\$ 852	\$ 468	\$ 1,835	\$ 496	\$ 64	\$3,715

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

## 6. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of June 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)	June 30, 2013		December 31, 2012	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill	\$ 3,664	\$ -	\$ 3,664	\$ -
Core deposit intangibles	4,027	2,937	4,027	2,792
Total	\$ 7,691	\$ 2,937	\$ 7,691	\$ 2,792

Goodwill resulted from three previous branch acquisitions. Goodwill represents the excess of the total purchase price paid for the branch acquisitions over the fair value of the assets acquired, net of the fair value of the liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. No goodwill impairment charges were recorded during 2012 or in the first six months of 2013. The core deposit intangible asset is amortized using the double declining balance method over a weighted average estimated life of nine years and is not estimated to have a significant residual value. During the three and six month periods ending June 30, 2013, the Corporation recorded intangible amortization expense totaling \$73,000 and \$145,000, respectively, compared to \$93,000 and \$186,000, respectively, for the same periods in the prior year.

## 7. Stock Compensation Plans

The Corporation's 2007 Stock Incentive Plan and Trust (the Plan), which is shareholder approved, permits the grant of restricted stock awards and options to its directors, officers and employees for up to 177,496 shares of common stock. Incentive stock options, non-incentive or compensatory stock options and share awards may be granted under the Plan. The exercise price of each option shall at least equal the market price of a share of common stock on the date of grant and have a contractual term of ten years. Options shall vest and become exercisable at the rate, to the extent and subject to such limitations as may be specified by the Corporation. Compensation cost related to share-based payment transactions must be recognized in the financial statements with measurement based upon the fair value of the equity instruments issued.

A summary of option activity under the Plan as of June 30, 2013, and changes during the period then ended is presented below:

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	Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Weighted-Average Remaining Term (in years)
Outstanding as of January 1, 2013	86,250	\$ 24.79	\$ -	4.9
Granted	-	-	-	-
Exercised	(1,500 )	13.50	-	-
Forfeited	(5,500 )	25.28	-	-
Outstanding as of June 30, 2013	79,250	\$ 24.97	\$ 65,295	4.3
Exercisable as of June 30, 2013	76,500	\$ 25.27	\$ 43,150	4.2

## 7. Stock Compensation Plans (continued)

A summary of the status of the Corporation's nonvested option shares as of June 30, 2013, and changes during the period then ended is presented below:

	Options	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2013	2,750	\$ 2.43
Granted	-	-
Vested	-	-
Forfeited	-	-
Nonvested as of June 30, 2013	2,750	\$ 2.43

A summary of the status of the Corporation's nonvested restricted stock awards as of June 30, 2013, and changes during the period then ended is presented below:

	Shares	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2013	25,650	\$ 17.30
Granted	-	-
Vested	(1,250 )	13.60
Forfeited	-	-
Nonvested as of June 30, 2013	24,400	\$ 17.49

For the three and six month periods ended June 30, 2013, the Corporation recognized \$63,000 and \$98,000, respectively, in stock compensation expense, compared to \$31,000 and \$60,000, respectively, for the same periods in 2012. As of June 30, 2013, there was \$224,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over the next 2.4 years. It is the Corporation's policy to issue shares on the vesting date for restricted stock awards. Unvested restricted stock awards do not receive dividends declared by the Corporation.

## 8. Employee Benefit Plans

The Corporation provides pension benefits for eligible employees through a defined benefit pension plan. Substantially all employees participate in the retirement plan on a non-contributory basis, and are fully vested after three years of service. Effective January 1, 2009, the plan was closed to new participants.

The Corporation provided the requisite notice to plan participants on March 12, 2013 of the determination to freeze the plan (curtailment). While the freeze was not effective until April 30, 2013, management determined that participants would not satisfy, within the provisions of the plan, 2013 eligibility requirements based on minimum hours worked for 2013. Therefore, employees ceased to earn benefits as of January 1, 2013. This amendment to the plan will not affect benefits earned by the participant prior to the date of the freeze.

## **9. Fair Value**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair value.

*Level 1:* Quoted prices (unadjusted) for identical assets or liabilities in active markets that the Corporation has the ability to access at the measurement date.

*Level 2:* Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

**9. Fair Value (continued)**

*Level 3:* Significant unobservable inputs that reflect the Corporation's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

An asset or liability's level is based on the lowest level of input that is significant to the fair value measurement.

The Corporation used the following methods and significant assumptions to estimate fair value:

*Cash and cash equivalents* – The carrying value of cash, due from banks and interest bearing deposits approximates fair value and are classified as Level 1.

*Securities available for sale* – The fair value of all investment securities are based upon the assumptions market participants would use in pricing the security. If available, investment securities are determined by quoted market prices (Level 1). Level 1 includes U.S. Treasury, federal agency securities and certain equity securities. For investment securities where quoted market prices are not available, fair values are calculated based on market prices on similar securities (Level 2). Level 2 includes U.S. Government sponsored entities and agencies, mortgage-backed securities, collateralized mortgage obligations, state and political subdivision securities and corporate debt securities. For investment securities where quoted prices or market prices of similar securities are not available, fair values are calculated by using unobservable inputs (Level 3) and may include certain equity securities held by the Corporation. The Level 3 equity security valuations were supported by an analysis prepared by the Corporation which relies on inputs such as the security issuer's publicly attainable financial information, multiples derived from prices in observed transactions involving comparable businesses and other market, financial and nonfinancial factors.

*Loans* – The fair value of loans receivable was estimated based on the discounted value of the future cash flows using the current rates being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification.

*Impaired loans* – At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive a specific allowance for loan losses. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a

single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result

in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. As of June 30, 2013, the fair value of impaired loans consists of loan balances of \$2.8 million, net of a valuation allowance of \$234,000, compared to loan balances of \$4.1 million, net of a valuation allowance of \$1.4 million, at December 31, 2012. There was \$20,000 of additional provision for loan losses recorded for impaired loans during the three and six month periods ended June 30, 2013. There was no additional provision for loan losses recorded for impaired loans during the three months ended June 30, 2012. Additional provision for loan losses of \$64,000 was recorded during the six months ended June 30, 2012 for impaired loans.



9.

**Fair Value (continued)**

*Other Real estate owned (OREO)* – Assets acquired through or instead of foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. Management's ongoing review of appraisal information may result in additional discounts or adjustments to the valuation based upon more recent market sales activity or more current appraisal information derived from properties of similar type and/or locale. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. As of June 30, 2013, OREO measured at fair value less costs to sell had a net carrying amount of \$35,000, which was made up of the outstanding balance of \$50,000 and write-downs of \$15,000, compared to a net carrying amount of \$45,000, which was made up of the outstanding balance of \$50,000 and write-downs of \$5,000 at December 31, 2012.

Appraisals for both collateral-dependent impaired loans and OREO are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed by the Corporation. Once received, management reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On an annual basis, the Corporation compares the actual selling price of OREO that has been sold to the most recent appraisal to determine what additional adjustment should be made to the appraisal value to arrive at fair value. The most recent analysis performed indicated that a discount of 10% should be applied.

*Federal bank stock* – It is not practical to determine the fair value of federal bank stocks due to restrictions placed on its transferability.

*Deposits* – The fair value of deposits with no stated maturity, such as non-interest bearing demand deposits, checking with interest, savings and money market accounts, is equal to the amount payable on demand resulting in either a Level 1 or Level 2 classification. The fair values of time deposits are based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar maturities resulting in a Level 2 classification.

*Borrowings* – The fair value of borrowings with the FHLB is estimated using discounted cash flows based on current incremental borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

*Accrued interest receivable and payable* – The carrying value of accrued interest receivable and payable approximates fair value. The fair value classification is consistent with the related financial instrument.



**9. Fair Value (continued)**

For assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

(Dollar amounts in thousands)		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Description	Total			
June 30, 2013:				
U.S. Treasury and federal agency	\$6,750	\$ 6,750	\$ -	\$ -
U.S. government sponsored entities and agencies	26,912	-	26,912	-
Mortgage-backed securities: residential	15,601	-	15,601	-
Collateralized mortgage obligations: residential	44,702	-	44,702	-
State and political subdivision	45,891	-	45,891	-
Corporate debt securities	3,986	-	3,986	-
Equity securities	2,439	1,786	-	653
	\$146,281	\$ 8,536	\$ 137,092	\$ 653
December 31, 2012:				
U.S. Treasury and federal agency	\$3,967	\$ 3,967	\$ -	\$ -
U.S. government sponsored entities and agencies	28,162	-	28,162	-
Mortgage-backed securities: residential	22,724	-	22,724	-
Collateralized mortgage obligations: residential	22,475	-	22,475	-
State and political subdivision	36,765	-	36,765	-
Corporate debt securities	3,761	-	3,761	-
Equity securities	2,352	1,699	-	653
	\$120,206	\$ 5,666	\$ 113,887	\$ 653

The Corporation's policy is to transfer assets or liabilities from one level to another when the methodology to obtain the fair value changes such that there are more or fewer unobservable inputs as of the end of the reporting period. During the three and six month periods ended June 30, 2013, the Corporation had no transfers between levels. The following table presents changes in Level 3 assets measured on a recurring basis for the three and six month periods ended June 30, 2013 and 2012:

(Dollar amounts in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Balance at the beginning of the period	\$ 653	\$ -	\$ 653	\$ -
Total gains or losses (realized/unrealized):	-	-	-	-
Included in earnings	-	-	-	-

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Included in other comprehensive income	-	-	-	-
Issuances	-	-	-	-
Transfers in and/or out of Level 3	-	-	-	-
Balance at the end of the period	\$ 653	\$ -	\$ 653	\$ -

**9. Fair Value (continued)**

For assets measured at fair value on a non-recurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

(Dollar amounts in thousands)		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Description	Total			
June 30, 2013:				
Impaired commercial real estate loans	\$2,510	\$ -	\$ -	\$ 2,510
Other residential real estate owned	35	-	-	35
	\$2,545	\$ -	\$ -	\$ 2,545
December 31, 2012:				
Impaired commercial real estate loans	\$2,620	\$ -	\$ -	\$ 2,620
Other residential real estate owned	45	-	-	45
	\$2,665	\$ -	\$ -	\$ 2,665

The following table presents quantitative information about Level 3 fair value measurements for assets measured at fair value on a non-recurring basis:

(Dollar amounts in thousands)		Valuation Techniques(s)	Unobservable Input (s)	Range
June 30, 2013:				
Impaired commercial real estate loans	\$2,510	Sales comparison approach/ Contractual provision of USDA loan	Adjustment for differences between comparable sales	0% - 20%
Other residential real estate owned	35	Sales comparison approach	Adjustment for differences between comparable sales	10%
December 31, 2012:				
Impaired commercial real estate loans	2,620	Sales comparison approach/ Contractual provision of USDA loan	Adjustment for differences between comparable sales	10% - 25%
Other residential real estate owned	45	Sales comparison approach	Adjustment for differences between comparable sales	10%

The two tables above exclude a \$61,000 impaired residential mortgage loan classified as a troubled debt restructure which was measured at fair value using a discounted cash flow methodology.

**9. Fair Value (continued)**

Included in impaired commercial real estate loans is a loan guaranteed by the United States Department of Agriculture (USDA) with balances of \$351,000 and \$354,000, respectively, as of June 30, 2013 and December 31, 2012. The guarantee covers 90% of the principal balance outstanding. In determining the fair value of this loan, the Corporation considered the contractual provisions of the loan and did not rely on the fair value of the underlying collateral. As such, the Corporation applied a 10% discount to the loan which represents the portion of the loan at risk. The weighted average discount on impaired loans as of June 30, 2013 and December 31, 2012 was 2% and 11%, respectively.

The following table sets forth the carrying amount and estimated fair values of the Corporation's financial instruments included in the consolidated balance sheet as of June 30, 2013 and December 31, 2012:

(Dollar amounts in thousands)

Description	Carrying Amount	Fair Value Total	Fair Value Measurements using:		
			Level 1	Level 2	Level 3
June 30, 2013:					
Financial Assets:					
Cash and cash equivalents	\$11,405	\$11,405	\$11,405	\$-	\$-
Securities available for sale	146,281	146,281	8,536	137,092	653
Loans, net	334,291	340,484	-	-	340,484
Federal bank stock	3,440	N/A	N/A	N/A	N/A
Accrued interest receivable	1,582	1,582	35	498	1,049
	496,999	499,752	19,976	137,590	342,186
Financial Liabilities:					
Deposits	449,497	451,714	331,083	120,631	-
FHLB advances	20,000	26,921	-	26,921	-
Accrued interest payable	377	377	7	370	-
	469,874	479,012	331,090	147,922	-
December 31, 2012:					
Financial Assets:					
Cash and cash equivalents	\$20,424	\$20,424	\$20,424	\$-	\$-
Securities available for sale	120,206	120,206	5,666	113,887	653
Loans, net	333,801	340,840	-	-	340,840
Federal bank stock	2,885	N/A	N/A	N/A	N/A
Accrued interest receivable	1,533	1,533	23	383	1,127
	478,849	483,003	26,113	114,270	342,620
Financial Liabilities:					

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Deposits	432,459	436,279	300,805	135,474	-
FHLB advances	20,000	22,613	-	22,613	-
Accrued interest payable	442	442	55	387	-
	452,901	459,334	300,860	158,474	-



### 10. Accumulated Other Comprehensive Income

The following tables summarize the changes within each classification of accumulated other comprehensive income, net of tax, for the three and six months ended June 30, 2013 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Income at April 1, 2013	\$ 2,071	\$(1,795)	\$276
Other comprehensive income before reclassification	(2,713	) -	(2,713)
Amounts reclassified from accumulated other comprehensive income	(65	) -	(65 )
Net current period other comprehensive loss	(2,778	) -	(2,778)
Accumulated Other Comprehensive Income at June 30, 2013	\$ (707	) \$(1,795)	\$(2,502)

(Dollar amounts in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income For the three months ended June 30, 2013	Affected Line Item in the Statement Where Net Income is Presented
Details about Accumulated Other Comprehensive Income Components		
Unrealized gains and losses on available-for-sale securities	\$ 99	Gain on sale of securities
	(34	) Tax expense
Total reclassifications for the period	\$ 65	Net of tax

(Dollar amounts in thousands)	Unrealized Gains and Losses on Available-for-Sale Securities	Defined Benefit Pension Items	Totals
Accumulated Other Comprehensive Income at January 1, 2013	\$ 2,365	\$(1,795)	\$570
Other comprehensive income before reclassification	(2,951	) -	(2,951)
Amounts reclassified from accumulated other comprehensive income	(121	) -	(121 )
Net current period other comprehensive loss	(3,072	) -	(3,072)
Accumulated Other Comprehensive Income at June 30, 2013	\$ (707	) \$(1,795)	\$(2,502)

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(Dollar amounts in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income For the six months ended June 30, 2013	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	\$ 184	Gain on sale of securities
	(63	) Tax expense
Total reclassifications for the period	\$ 121	Net of tax

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This section discusses the consolidated financial condition and results of operations of Emclair Financial Corp and its wholly owned subsidiaries, the Bank and the Title Company, for the three and six months ended June 30, 2013, compared to the same periods in 2012 and should be read in conjunction with the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 26 of this Form 10-Q.

This Form 10-Q, including the financial statements and related notes, contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, objectives, expected operating results and the assumptions upon which those statements are based. Forward looking statements include without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and are typically identified with words such as "may," "could," "should," "will," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan" or words or phrases of similar meaning. We caution that the forward looking statements are based largely on our expectations and are subject to a number of known and unknown risks and uncertainties that are subject to change based on factors which are, in many instances, beyond our control. Actual results, performances or achievements could differ materially from those contemplated, expressed or implied by the forward looking statements. Therefore, we caution you not to place undue reliance on our forward looking information and statements. Except as required by applicable law or regulation, we will not update the forward looking statements to reflect actual results or changes in factors affecting the forward looking statements.

### **CHANGES IN FINANCIAL CONDITION**

Total assets increased \$20.6 million, or 4.1%, to \$529.6 million at June 30, 2013 from \$509.0 million at December 31, 2012. This increase resulted primarily from increases in securities and premises and equipment of \$26.1 million and \$1.9 million, respectively, which was funded by a decrease in cash and due from banks of \$9.0 million and increases in customer deposits and short-term borrowed funds of \$17.0 million and \$5.5 million, respectively. The increase in premises and equipment relates primarily to the purchase of property for the construction of a new branch office in Cranberry Township, Pennsylvania.

Total liabilities increased \$22.7 million, or 5.0%, to \$480.0 million at June 30, 2013 from \$457.3 million at December 31, 2012, resulting primarily from the aforementioned \$17.0 million increase in customer deposits, which consisted of a \$7.9 million, or 8.0%, increase in noninterest bearing deposits and a \$9.2 million, or 2.7%, increase in interest bearing deposits. Borrowed funds increased \$5.5 million, or 27.5% as the Corporation utilized short-term advances to fund normal fluctuations in cash balances.

Stockholders' equity decreased \$2.1 million to \$49.6 million at June 30, 2013 from \$51.7 million at December 31, 2012. This resulted from a \$3.1 million decrease in accumulated other comprehensive income as unrealized gains on the Corporation's securities portfolio decreased by \$4.7 million following the recent rise in market interest rates. Book value and tangible book value per common share was \$22.48 and \$19.78, respectively, at June 30, 2013, compared to \$23.72 and \$20.93, respectively, at December 31, 2012.

At June 30, 2013, the Bank was considered well capitalized under regulatory guidelines with a Tier 1 leverage ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 8.80%, 14.75% and 16.00%, respectively, compared to 8.92%, 14.96% and 16.21%, respectively, at December 31, 2012.

In July 2013, the Office of the Comptroller of the Currency and the other federal bank regulatory agencies issued a final rule that will revise their leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule established a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain “available-for-sale” securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-in or opt-out is exercised. The rule limits a banking organization’s capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements.

The final rule becomes effective for the Bank on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective. The final rule also implements consolidated capital requirements for bank holding companies, such as the Corporation, effective January 1, 2015.

## RESULTS OF OPERATIONS

### Comparison of Results for the Three Month Periods Ended June 30, 2013 and 2012

**General.** Net income before preferred stock dividends decreased \$317,000, or 25.2%, to \$939,000 for the three months ended June 30, 2013 from \$1.3 million for the same period in 2012. This decrease was the result of decreases in net interest income and noninterest income of \$37,000 and \$390,000, respectively, and increases in the provision for loan losses and noninterest expense of \$38,000 and \$68,000, respectively, partially offset by a decrease in the provision for income taxes of \$216,000.

**Net interest income.** Net interest income on a tax equivalent basis decreased \$34,000, or 1.0%, to \$4.1 million for the three months ended June 30, 2013. This decrease can be attributed to a decrease in tax equivalent interest income of \$297,000, partially offset by a decrease in interest expense of \$263,000.

**Interest income.** Interest income on a tax equivalent basis decreased \$297,000, or 5.5%, to \$5.1 million for the three months ended June 30, 2013 compared to \$5.4 million for the three months ended June 30, 2012. This decrease can be attributed to decreases in interest on loans, securities and interest-earning deposits with banks of \$186,000, \$102,000

and \$11,000, respectively, partially offset by an increase in interest earned on federal bank stocks of \$2,000.

Tax equivalent interest earned on loans receivable decreased \$186,000, or 4.3%, to \$4.2 million for the three months ended June 30, 2013 compared to \$4.4 million for the three months ended June 30, 2012. This decrease resulted from a 42 basis points decline in the average yield on loans to 4.95% for the three months ended June 30, 2013, versus 5.37% for the same period in 2012. This unfavorable yield variance accounted for a \$337,000 decrease in interest income. Partially offsetting this unfavorable yield variance, average loans increased \$11.6 million, or 3.6%, accounting for an increase of \$151,000 in loan interest income. Management's strategy to increase loan production capacity, which includes the expansion of the corporate banking team and the projected entrance into new markets in the coming quarters, is key to overcoming the decrease in loan yields caused by an overall decline in market interest rates.

Tax equivalent interest earned on securities decreased \$102,000, or 10.3%, to \$885,000 for the three months ended June 30, 2013 as compared to \$987,000 for the three months ended June 30, 2012. This decrease resulted from a 32 basis point decline in the average yield on securities to 2.48% for the three months ended June 30, 2013, versus 2.80% for the same period in 2012, due primarily to calls of higher-yielding securities. This unfavorable yield variance accounted for a \$111,000 decrease in interest income. Partially offsetting the unfavorable yield variance, the average balance of securities increased \$1.3 million, or 1.0%, accounting for a \$9,000 increase in interest income.

**Interest expense.** Interest expense decreased \$263,000, or 20.8%, to \$1.0 million for the three months ended June 30, 2013 from \$1.3 million for the same period in 2012. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$222,000 and \$41,000, respectively.

Interest expense incurred on deposits decreased \$222,000, or 21.6%, to \$805,000 for the three months ended June 30, 2013 compared to \$1.0 million for the same period in 2012. The average cost of interest-bearing deposits decreased 21 basis points to 0.93% for the three months ended June 30, 2013, compared to 1.14% for the same period in 2012, resulting in a \$180,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during late 2012 and the first six months of 2013 in the overall low interest-rate environment. Additionally, the average balance of interest-bearing deposits decreased \$15.4 million, or 4.3%, to \$345.5 million for the three months ended June 30, 2013, compared to \$360.9 million for the same period in 2012 causing a \$42,000 decrease in interest expense. Average noninterest bearing deposits increased \$10.4 million, or 10.9%, to \$105.7 million from \$95.3 million, facilitating the overall decline in the Corporation's cost of funds.

Interest expense incurred on borrowed funds decreased \$41,000, or 17.4%, to \$194,000 for the three months ended June 30, 2013, compared to \$235,000 for the same period in the prior year. The average cost of borrowed funds decreased 111 basis points to 3.62% for the three months ended June 30, 2013, compared to 4.73% for the same period in 2012, causing a \$57,000 decrease in interest expense. This was primarily the result of the Corporation having exchanged and modified \$15.0 million of the \$20.0 million in outstanding Federal Home Loan Bank (FHLB) advances during the fourth quarter of 2012. The three \$5.0 million advances with original rates of 4.98%, 4.83% and 4.68%, respectively, were exchanged for three \$5.0 million advances each with a rate of 0.93% and a term of five years. Prepayment penalties associated with the three modified advances totaled \$2.3 million and were cash-settled with the FHLB at the time of the modification. The Corporation is amortizing this prepayment penalty over the life of the new advances. Partially offsetting the favorable rate variance, the average balance of borrowed funds increased \$1.4 million, or 7.2%, to \$21.4 million for the three months ended June 30, 2013, compared to \$20.0 million for the same period in 2012 causing a \$16,000 increase in interest expense.

**Average Balance Sheet and Yield/Rate Analysis.** The following table sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resulting average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resulting average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average loan balances include nonaccrual loans and exclude the allowance for loan losses and interest income includes accretion of net deferred loan fees. Interest and yields on tax-exempt loans and securities (tax-exempt for federal income tax purposes) are shown on a fully tax equivalent basis. The information is based on average daily balances during the periods presented.

(Dollar amounts in thousands)	Three months ended June 30,					
	2013			2012		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$318,536	\$3,928	4.95 %	\$304,838	\$4,124	5.44 %
Loans, tax exempt	19,217	243	5.06 %	21,303	233	4.40 %
Total loans receivable	337,753	4,171	4.95 %	326,141	4,357	5.37 %
Securities, taxable	100,690	470	1.87 %	105,263	578	2.21 %
Securities, tax exempt	42,346	415	3.93 %	36,522	409	4.50 %
Total securities	143,036	885	2.48 %	141,785	987	2.80 %
Interest-earning deposits with banks	16,628	18	0.43 %	38,387	29	0.30 %
Federal bank stocks	2,935	17	2.32 %	3,444	15	1.75 %
Total interest-earning other assets	19,563	35	0.72 %	41,831	44	0.42 %
Total interest-earning assets	500,352	5,091	4.08 %	509,757	5,388	4.25 %
Cash and due from banks	2,062			2,507		
Other noninterest-earning assets	27,241			20,452		
<b>Total Assets</b>	<b>\$529,655</b>			<b>\$532,716</b>		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$225,068	\$94	0.17 %	\$219,777	\$122	0.22 %
Time deposits	120,455	711	2.37 %	141,133	905	2.58 %
Total interest-bearing deposits	345,523	805	0.93 %	360,910	1,027	1.14 %
Borrowed funds, short-term	1,447	1	0.25 %	-	-	0.00 %
Borrowed funds, long-term	20,000	193	3.86 %	20,000	235	4.73 %
Total borrowed funds	21,447	194	3.62 %	20,000	235	4.73 %
Total interest-bearing liabilities	366,970	999	1.09 %	380,910	1,262	1.33 %
Noninterest-bearing demand deposits	105,684	-	-	95,275	-	-



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Funding and cost of funds	472,654	999	0.85 %	476,185	1,262	1.07 %
Other noninterest-bearing liabilities	5,195			4,926		
Total Liabilities	477,849			481,111		
Stockholders' Equity	51,806			51,605		
Total Liabilities and Stockholders' Equity	\$529,655			\$532,716		
Net interest income		\$4,092			\$4,126	
<b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			2.99 %			2.92 %
<b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)			3.28 %			3.26 %

**Analysis of Changes in Net Interest Income.** The following table analyzes the changes in interest income and interest expense in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Corporation's interest income and interest expense are attributable to changes in volume (changes in volume multiplied by prior year rate), rate (change in rate multiplied by prior year volume) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on loans and securities reflect the changes in interest income on a fully tax equivalent basis.

(Dollar amounts in thousands)	Three months ended June 30, 2013 versus 2012		
	Increase (Decrease) due to		
	Volume	Rate	Total
Interest income:			
Loans	\$ 151	\$ (337 )	\$ (186 )
Securities	9	(111 )	(102 )
Interest-earning deposits with banks	(20 )	9	(11 )
Federal bank stocks	(2 )	4	2
Total interest-earning assets	138	(435 )	(297 )
Interest expense:			
Interest-bearing deposits	(42 )	(180 )	(222 )
Borrowed funds	16	(57 )	(41 )
Total interest-bearing liabilities	(26 )	(237 )	(263 )
Net interest income	\$ 164	\$ (198 )	\$ (34 )

**Provision for loan losses.** The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all probable incurred losses estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of nonperforming assets, the estimated underlying value of the collateral and other factors related to the collectability of the loan portfolio.

Information pertaining to the allowance for loan losses and nonperforming assets for the quarter ended June 30, 2013 and 2012 is as follows:

(Dollar amounts in thousands)	At or for the three months ended	
	June 30,	
	2013	2012
Balance at the beginning of the period	\$ 5,488	\$ 3,642

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Provision for loan losses	153		115	
Charge-offs	(978	)	(76	)
Recoveries	7		34	
Balance at the end of the period	\$ 4,670		\$ 3,715	
Nonperforming loans	\$ 5,329		\$ 3,904	
Nonperforming assets	5,564		4,211	
Nonperforming loans to total loans	1.57	%	1.18	%
Nonperforming assets to total assets	1.05	%	0.78	%
Allowance for loan losses to total loans	1.38	%	1.13	%
Allowance for loan losses to non-performing loans	87.63	%	95.16	%

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Nonperforming loans increased \$1.4 million to \$5.3 million at June 30, 2013 from \$3.9 million at June 30, 2012. The increase in nonperforming loans was primarily due to a \$3.4 million commercial real estate relationship identified as impaired and placed on nonaccrual status during the quarter ended September 30, 2012 due to cash flow considerations, weakened financial condition of the principals and guarantors and updated appraisal information. Partially offsetting this addition were principal reductions resulting from credit workouts and repayments and a \$941,000 partial charge-off in the second quarter of 2013 of the aforementioned loan for which a specific reserve of \$1.4 million was established in the third quarter of 2012. Of the \$5.3 million in nonperforming loans, the Corporation continues to receive payments on \$4.2 million. During the three months ended June 30, 2013, nonperforming loans decreased \$1.5 million to \$5.3 million from \$6.8 million at March 31, 2013.

As of June 30, 2013, the Corporation's classified and criticized assets amounted to \$13.2 million, or 2.5% of total assets, with \$12.0 million classified as substandard and \$1.2 million identified as special mention. This compares to classified and criticized assets of \$15.4 million, or 3.0% of total assets, with \$10.2 million classified as substandard, \$3.8 million identified as special mention and \$1.4 million classified as doubtful at December 31, 2012. The overall decrease in criticized and classified assets was primarily the result of the aforementioned partial charge-off and principal reductions resulting from credit workouts and repayments.

The provision for loan losses increased \$38,000, or 33.0%, to \$153,000 for the three months ended June 30, 2013 from \$115,000 for the same period in the prior year as average loans receivable increased \$11.6 million, or 3.6%, to \$337.8 million for the three months ended June 30, 2013 compared to \$326.1 million for the same period in 2012. Net charge-offs for the three month period ended June 30, 2013 were \$971,000, compared to \$42,000 for the same period in 2012 due to the aforementioned partial charge-off. This loan had sufficient specific reserves allocated to cover the charge-off, however, the charge-off negatively impacted the historical loss factors requiring additional provision for loan losses for the commercial real estate loan portfolio.

**Noninterest income.** Noninterest income decreased \$390,000, or 27.5%, to \$1.0 million during the three months ended June 30, 2013, compared to \$1.4 million for the same period in the prior year. This decrease was primarily due to decreases in gains on the sale of securities and commissions on financial services of \$439,000 and \$63,000, respectively. During the quarter ended June 30, 2013, the Corporation realized securities gains of \$99,000 related to the sale of certain mortgage-backed securities that were experiencing accelerated prepayments. During the same period in 2012, the Corporation realized securities gains of \$538,000 related to the sale of U.S. Treasury securities. Partially offsetting these decreases, fees and service charges and earnings on bank-owned life insurance increased by \$53,000 and \$34,000, respectively. During the third quarter of 2012, the Corporation purchased an additional \$4.0 million of bank-owned life insurance, thereby increasing its total investment to over \$10.0 million. Excluding security gains, noninterest income increased \$49,000, or 5.5%, to \$932,000 during the three months ended June 30, 2013, compared to \$883,000 for the same period in the prior year.

**Noninterest expense.** Noninterest expense increased \$68,000, or 1.9%, to \$3.6 million for the three months ended June 30, 2013. This increase in noninterest expense can be attributed to increases in compensation and employee benefits expense, premise and equipment expense, professional fees and FDIC expense of \$65,000, \$27,000, \$3,000

and \$8,000, respectively, partially offset by decreases in intangible amortization and other noninterest expense of \$20,000 and \$15,000, respectively.

Compensation and employee benefits expense increased \$65,000, or 3.5%, to \$1.9 million for the three months ended June 30, 2013. This increase can be primarily attributed to normal salary and wage increases of \$111,000 and increases in stock compensation expense and recruitment and hiring expenses of \$32,000 and \$31,000, respectively, partially offset by a \$39,000 reduction in employee retirement expense related to the pension plan freeze and decreases of \$20,000 and \$42,000, respectively in incentive compensation and employee insurance expense.

Premise and equipment expense increased \$27,000, or 5.4%, to \$527,000 for the three months ended June 30, 2013 from \$500,000 for the same period in the prior year. This increase can be primarily attributed to increases of \$7,000, \$6,000 \$5,000 and \$5,000 in office rent, utility expense, real estate taxes and equipment repairs, respectively.

The Corporation recognized \$73,000 of core deposit intangible amortization expense during the second quarter of 2013 compared to \$93,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the “Notes to Consolidated Financial Statements” beginning on page 6.

FDIC insurance increased \$8,000, or 8.5%, to \$102,000 for the three months ended June 30, 2013, compared to \$94,000 for the same period in the prior year. This was the result of prior period increases in nonperforming assets, which negatively impacted certain ratios used in calculating the FDIC insurance assessment rate.

**Provision for income taxes.** The provision for income taxes decreased \$216,000, or 51.2%, to \$206,000 for the three months ended June 30, 2013 compared to \$422,000 for the same period in the prior year. The Corporation’s effective tax rate decreased to 18.0% for the second quarter of 2013 from 25.1% for the same quarter in the prior year due to a decrease in taxable income. The difference between the statutory rate of 34% and the Corporation’s effective tax rate of 18.0% for the quarter ended June 30, 2013, was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

#### Comparison of Results for the Six Month Periods Ended June 30, 2013 and 2012

**General.** Net income before preferred stock dividends decreased \$497,000, or 21.7%, to \$1.8 million for the six months ended June 30, 2013 from \$2.3 million for the same period in 2012. This decrease was the result of decreases in net interest income and noninterest income of \$71,000 and \$679,000, respectively, and increases in the provision for loan losses and noninterest expense of \$67,000 and \$9,000, respectively, partially offset by a decrease in the provision for income taxes of \$329,000.

**Net interest income.** Net interest income on a tax equivalent basis decreased \$82,000, or 1.0%, to \$8.1 million for the six months ended June 30, 2013 from \$8.2 million for the same period in 2012. This decrease can be attributed to a decrease in tax equivalent interest income of \$613,000, partially offset by a decrease in interest expense of \$531,000.

**Interest income.** Interest income on a tax equivalent basis decreased \$613,000, or 5.7%, to \$10.2 million for the six months ended June 30, 2013 compared to \$10.8 million for the six months ended June 30, 2012. This decrease can be attributed to decreases in interest on loans, securities and interest-earning deposits with banks of \$298,000, \$300,000 and \$19,000, respectively, partially offset by an increase in interest earned on federal bank stocks of \$4,000.

Tax equivalent interest earned on loans receivable decreased \$289,000, or 3.4%, to \$8.4 million for the six months ended June 30, 2013 compared to \$8.7 million for the six months ended June 30, 2012. This decrease resulted from a 43 basis point decline in the average yield on loans to 5.00% for the six months ended June 30, 2013, versus 5.43% for the same period in 2012. This unfavorable yield variance accounted for a \$733,000 decrease in interest income. Partially offsetting this unfavorable yield variance, average loans increased \$16.7 million, or 5.1%, accounting for an increase of \$435,000 in loan interest income. Management's strategy to increase loan production capacity, which includes the expansion of the corporate banking team and the projected entrance into new markets in the coming quarters, is key to overcoming the decrease in loan yields caused by an overall decline in market interest rates.

Tax equivalent interest earned on securities decreased \$300,000, or 15.2%, to \$1.7 million for the six months ended June 30, 2013 compared to \$2.0 million for the six months ended June 30, 2012. This decrease resulted from a 31 basis point decline in the average yield on securities to 2.63% for the six months ended June 30, 2013, versus 2.94% for the same period in 2012, due primarily to calls of higher-yielding securities. This unfavorable yield variance accounted for a \$206,000 decrease in interest income. Additionally, the average balance of securities decreased \$6.7 million, or 4.9%, accounting for a \$94,000 decrease in interest income.

**Interest expense.** Interest expense decreased \$531,000, or 20.7%, to \$2.0 million for the six months ended June 30, 2013 from \$2.6 million for the same period in 2012. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$453,000 and \$78,000, respectively.

Interest expense incurred on deposits decreased \$453,000, or 21.6%, to \$1.6 million for the six months ended June 30, 2013 compared to \$2.1 million for the same period in 2012. The average cost of interest-bearing deposits decreased 22 basis points to 0.99% for the three months ended June 30, 2013, compared to 1.21% for the same period in 2012, resulting in a \$379,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during late 2012 and the first six months of 2013 in the overall low interest-rate environment. Additionally, the average balance of interest-bearing deposits decreased \$12.7 million, or 3.7%, to \$335.5 million for the six months ended June 30, 2013, compared to \$348.2 million for the same period in 2012, causing a \$74,000 decrease in interest expense. Average noninterest bearing deposits increased \$11.2 million, or 12.3%, to \$102.5 million from \$91.3 million, facilitating the overall decline in the Corporation's cost of funds.

Interest expense incurred on borrowed funds decreased \$78,000, or 16.6%, to \$392,000 for the six months ended June 30, 2013, compared to \$470,000 for the same period in the prior year. The average cost of borrowed funds decreased 94 basis points to 3.79% for the six months ended June 30, 2013, compared to 4.73% for the same period in 2012, causing a \$97,000 decrease in interest expense. This was primarily the result of the Corporation having exchanged and modified \$15.0 million of the \$20.0 million in outstanding Federal Home Loan Bank (FHLB) advances during the fourth quarter of 2012. The three \$5.0 million advances with original rates of 4.98%, 4.83% and 4.68%, respectively, were exchanged for three \$5.0 million advances each with a rate of 0.93% and a term of five years. Prepayment penalties associated with the three modified advances totaled \$2.3 million and were cash-settled with the FHLB at the time of the modification. The Corporation is amortizing this prepayment penalty over the life of the new advances. Partially offsetting the favorable rate variance, the average balance of borrowed funds increased \$822,000, or 4.1%, to \$20.8 million for the six months ended June 30, 2013, compared to \$20.0 million for the same period in 2012, causing a \$19,000 increase in interest expense.



**Average Balance Sheet and Yield/Rate Analysis.** The following table sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resulting average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resulting average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average loan balances include nonaccrual loans and exclude the allowance for loan losses and interest income includes accretion of net deferred loan fees. Interest and yields on tax-exempt loans and securities (tax-exempt for federal income tax purposes) are shown on a fully tax equivalent basis. The information is based on average daily balances during the periods presented.

(Dollar amounts in thousands)	Six months ended June 30,					
	2013			2012		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Loans, taxable	\$322,241	\$7,977	4.99 %	\$303,024	\$8,281	5.50 %
Loans, tax exempt	18,019	458	5.13 %	20,581	452	4.42 %
Total loans receivable	340,260	8,435	5.00 %	323,605	8,733	5.43 %
Securities, taxable	89,182	887	2.01 %	98,532	1,147	2.34 %
Securities, tax exempt	39,455	792	4.05 %	36,770	832	4.55 %
Total securities	128,637	1,679	2.63 %	135,302	1,979	2.94 %
Interest-earning deposits with banks	15,196	31	0.41 %	30,381	50	0.33 %
Federal bank stocks	2,897	35	2.44 %	3,527	31	1.77 %
Total interest-earning cash equivalents	18,093	66	0.74 %	33,908	81	0.48 %
Total interest-earning assets	486,990	10,180	4.22 %	492,815	10,793	4.40 %
Cash and due from banks	1,996			2,562		
Other noninterest-earning assets	26,755			20,584		
Total assets	\$515,741			\$515,961		
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$211,812	\$164	0.16 %	\$205,326	\$225	0.22 %
Time deposits	123,698	1,479	2.41 %	142,901	1,871	2.63 %
Total interest-bearing deposits	335,510	1,643	0.99 %	348,227	2,096	1.21 %
Borrowed funds, long-term	20,000	391	3.94 %	20,000	470	4.73 %
Borrowed funds, short-term	822	1	0.26 %	-	-	0.00 %
Total borrowed funds	20,822	392	3.79 %	20,000	470	4.73 %
Total interest-bearing liabilities	356,332	2,035	1.15 %	368,227	2,566	1.40 %
Noninterest-bearing demand deposits	102,467	-	-	91,262	-	-
Funding and cost of funds	458,799	2,035	0.89 %	459,489	2,566	1.12 %

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Other noninterest-bearing liabilities	5,142		5,085	
Total liabilities	463,941		464,574	
Stockholders' equity	51,800		51,387	
Total liabilities and stockholders' equity	\$515,741		\$515,961	
Net interest income		\$8,145		\$8,227
<b>Interest rate spread</b> (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)			3.07 %	3.00 %
<b>Net interest margin</b> (net interest income as a percentage of average interest-earning assets)			3.37 %	3.36 %

**Analysis of Changes in Net Interest Income.** The following table analyzes the changes in interest income and interest expense in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Corporation's interest income and interest expense are attributable to changes in volume (changes in volume multiplied by prior year rate), rate (change in rate multiplied by prior year volume) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on loans and securities reflect the changes in interest income on a fully tax equivalent basis.

(Dollar amounts in thousands)	Six months ended		
	June 30, 2013 versus 2012		
	Increase (Decrease)		
	due to		
	Volume	Rate	Total
Interest income:			
Loans	\$435	\$(733)	\$(298)
Securities	(94)	(206)	(300)
Interest-earning deposits with banks	(29)	10	(19)
Federal bank stocks	(6)	10	4
Total interest-earning assets	306	(919)	(613)
Interest expense:			
Deposits	(74)	(379)	(453)
Borrowed funds	19	(97)	(78)
Total interest-bearing liabilities	(55)	(476)	(531)
Net interest income	\$361	\$(443)	\$(82)

**Provision for loan losses.** The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all probable incurred losses estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of nonperforming assets, the estimated underlying value of the collateral and other factors related to the collectability of the loan portfolio.

Information pertaining to the allowance for loan losses and nonperforming assets for the six months ended June 30, 2013 and 2012 is as follows:

(Dollar amounts in thousands)	At or for the six months ended	
	June 30,	
	2013	2012
Balance at the beginning of the period	\$ 5,350	\$ 3,536

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Provision for loan losses	295		228	
Charge-offs	(1,014	)	(188	)
Recoveries	39		139	
Balance at the end of the period	\$ 4,670		\$ 3,715	
Non-performing loans	\$ 5,329		\$ 3,904	
Non-performing assets	5,564		4,211	
Non-performing loans to total loans	1.57	%	1.18	%
Non-performing assets to total assets	1.05	%	0.78	%
Allowance for loan losses to total loans	1.38	%	1.13	%
Allowance for loan losses to non-performing loans	87.63	%	95.16	%

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Nonperforming loans increased \$1.4 million to \$5.3 million at June 30, 2013 from \$3.9 million at June 30, 2012. The increase in nonperforming loans was primarily due to a \$3.4 million commercial real estate relationship identified as impaired and placed on nonaccrual status during the quarter ended September 30, 2012 due to cash flow considerations, weakened financial condition of the principals and guarantors and updated appraisal information. Partially offsetting this addition were principal reductions resulting from credit workouts and repayments and a \$941,000 partial charge-off in the second quarter of 2013 of the aforementioned loan for which a specific reserve of \$1.4 million was established in the third quarter of 2012. Of the \$5.3 million in nonperforming loans, the Corporation continues to receive payments on \$4.2 million. During the six months ended June 30, 2013, nonperforming loans decreased \$1.7 million to \$5.3 million from \$7.0 million at December 31, 2012.

As of June 30, 2013, the Corporation's classified and criticized assets amounted to \$13.2 million, or 2.5% of total assets, with \$12.0 million classified as substandard and \$1.2 million identified as special mention. This compares to classified and criticized assets of \$15.4 million, or 3.0% of total assets, with \$10.2 million classified as substandard, \$3.8 million identified as special mention and \$1.4 million classified as doubtful at December 31, 2012. The overall decrease in criticized and classified assets was primarily the result of the aforementioned partial charge-off and principal reductions resulting from credit workouts and repayments.

The provision for loan losses increased \$67,000, or 29.4%, to \$295,000 for the six months ended June 30, 2013 from \$228,000 for the same period in the prior year as average loans receivable increased \$16.7 million, or 5.1%, to \$340.3 million for the six months ended June 30, 2013 compared to \$323.6 million for the same period in 2012. Net charge-offs for the six months ended June 30, 2013 were \$975,000, compared to \$49,000 for the same period in 2012 due to the aforementioned partial charge-off. This loan had sufficient specific reserves allocated to cover the charge-off, however, the charge-off negatively impacted the historical loss factors requiring additional provision for loan losses for the commercial real estate loan portfolio.

**Noninterest income.** Noninterest income decreased \$679,000, or 25.7%, to \$2.0 million during the six months ended June 30, 2013, compared to \$2.6 million for the same period in the prior year. This decrease was primarily due to decreases in gains on the sale of securities and commissions on financial services of \$778,000 and \$86,000, respectively. During the six months ended June 30, 2013, the Corporation realized securities gains of \$184,000 related to the sale of certain mortgage-backed securities that were experiencing accelerated prepayments. During the same period in 2012, the Corporation realized securities gains of \$962,000, \$424,000 of which related to the sale of a community bank stock and \$538,000 related to the sale of U.S. Treasury securities. Partially offsetting these decreases, fees and service charges and earnings on bank-owned life insurance increased by \$95,000 and \$68,000, respectively. During the third quarter of 2012, the Corporation purchased an additional \$4.0 million of bank-owned life insurance, thereby increasing its total investment to over \$10.0 million. Excluding securities gains, noninterest income increased \$99,000, or 5.9%, to \$1.8 million during the six months ended June 30, 2013, compared to \$1.7 million for the same period in the prior year.

**Noninterest expense.** Noninterest expense increased \$9,000 to \$7.2 million for the six months ended June 30, 2013. This increase in noninterest expense can be attributed to increases in compensation and employee benefits expense,

premise and equipment expense and FDIC expense of \$27,000, \$50,000 and \$17,000, respectively, partially offset by decreases in intangible amortization, professional fees and other noninterest expense of \$40,000, \$20,000 and \$15,000, respectively.

Compensation and employee benefits expense increased \$27,000, or 1.0%, to \$3.8 million for the six months ended June 30, 2013. This increase can be primarily attributed to normal salary and wage increases of \$173,000 and an increase in stock compensation expense of \$38,000, partially offset by a \$78,000 reduction in employee retirement expense related to the pension plan freeze and decreases of \$45,000, \$20,000, \$18,000 and \$17,000 in incentive compensation, payroll taxes, commission expense and recruitment and hiring expense, respectively.

Professional fees decreased \$20,000, or 5.3%, to \$355,000 for the six months ended June 30, 2013 from \$375,000 for the same period in the prior year. This decrease can be primarily attributed to a \$53,000 decrease in legal fees mainly related to declines in foreclosure and loan workout activity, partially offset by an increase in other professional fees of \$19,000 related to information technology consulting and an increase in accounting and auditing fees of \$13,000.

The Corporation recognized \$145,000 of core deposit intangible amortization expense during the first six months of 2013 compared to \$186,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the “Notes to Consolidated Financial Statements” beginning on page 6.

Premises and equipment expense increased \$50,000, or 4.9%, to \$1.1 million for the six months ended June 30, 2013 from \$1.0 million for the same period in the prior year. This increase can be primarily attributed to increases of \$10,000, \$8,000 \$6,000 and \$11,000 in office rent, utility expense, real estate taxes and equipment repairs, respectively.

FDIC insurance increased \$18,000, or 9.3%, to \$208,000 for the six months ended June 30, 2013, compared to \$190,000 for the same period in the prior year. This was the result of prior period increases in nonperforming assets, which negatively impacted certain ratios used in calculating the FDIC insurance assessment rate.

**Provision for income taxes.** The provision for income taxes decreased \$329,000, or 42.8%, to \$439,000 for the six months ended June 30, 2013 compared to \$768,000 for the same period in the prior year. The Corporation’s effective tax rate decreased to 19.6% for the first six months of 2013 from 25.1% for the same period in the prior year due to a decrease in taxable income. The difference between the statutory rate of 34% and the Corporation’s effective tax rate of 19.6% for the period ended June 30, 2013, was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

## LIQUIDITY

The Corporation’s primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB and Federal Reserve, and amortization and prepayments of outstanding loans and maturing securities. During the six months ended June 30, 2013, the Corporation used its sources of funds primarily to fund loan originations and security purchases. As of June 30, 2013, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$58.7 million, and standby letters of credit totaling \$188,000.

At June 30, 2013, time deposits amounted to \$118.4 million, or 26.3% of the Corporation’s total consolidated deposits, including approximately \$42.4 million of which are scheduled to mature within the next year. Management of the Corporation believes (i) it has adequate resources to fund all of its commitments, (ii) all of its commitments will be funded as required by related maturity dates and (iii) based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities if necessary.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation has alternative sources of funds such as a term borrowing capacity from the FHLB and the Federal Reserve's discount window. At June 30, 2013, the Corporation had borrowed funds of \$25.5 million consisting of \$20.0 million in long-term FHLB advances and \$5.5 million in short-term FHLB advances. The short-term borrowed funds were utilized primarily to fund purchases of certain investment securities and to offset deposit fluctuations within the quarter. At June 30, 2013, the Corporation's borrowing capacity with the FHLB, net of funds borrowed, was \$151.8 million.

Management is not aware of any conditions, including any regulatory recommendations or requirements, which would adversely impact its liquidity or its ability to meet funding needs in the ordinary course of business.



## CRITICAL ACCOUNTING POLICIES

The Corporation's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industry in which it operates. Application of these principles requires management to make estimates or judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates or judgments. Certain policies inherently have a greater reliance on the use of estimates, and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates or judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by third-party sources, when available. When third-party information is not available, valuation adjustments are estimated in good faith by management primarily through the use of internal cash flow modeling techniques.

The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012. These policies, along with the disclosures presented in the other financial statement notes provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Management views critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates and assumptions and where changes in those estimates and assumptions could have a significant impact on the financial statements. Management has identified the following as critical accounting policies.

***Allowance for loan losses.*** The Corporation considers that the determination of the allowance for loan losses involves a higher degree of judgment and complexity than its other significant accounting policies. The balance in the allowance for loan losses is determined based on management's review and evaluation of the loan portfolio in relation to past loss experience, the size and composition of the portfolio, current economic events and conditions and other pertinent factors, including management's assumptions as to future delinquencies, recoveries and losses. All of these factors may be susceptible to significant change. Among the many factors affecting the allowance for loan losses, some are quantitative while others require qualitative judgment. Although management believes its process for determining the allowance adequately considers all of the potential factors that could potentially result in credit losses, the process includes subjective elements and may be susceptible to significant change. To the extent actual outcomes differ from management's estimates, additional provisions for loan losses may be required that would adversely impact the Corporation's financial condition or earnings in future periods.

***Other-than-temporary impairment.*** Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic, market or other concerns warrant such evaluation.

Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions and (4) whether the Corporation has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery.

***Goodwill and intangible assets.*** Goodwill represents the excess cost over fair value of assets acquired in a business combination. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values. The impairment test is a two-step process that begins with an initial impairment evaluation. If the initial evaluation suggests that an impairment of the asset value exists, the second step is to determine the amount of the impairment. If the tests conclude that goodwill is impaired, the carrying value is adjusted and an impairment charge is recorded. As of November 30, 2012, the required annual impairment test of goodwill was performed and management concluded that no impairment existed as of that date.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk for the Corporation consists primarily of interest rate risk exposure and liquidity risk. Since virtually all of the interest-earning assets and interest-bearing liabilities are at the Bank, virtually all of the interest rate risk and liquidity risk lies at the Bank level. The Bank is not subject to currency exchange risk or commodity price risk, and has no trading portfolio, and therefore, is not subject to any trading risk. In addition, the Bank does not participate in hedging transactions such as interest rate swaps and caps. Changes in interest rates will impact both income and expense recorded and also the market value of long-term interest-earning assets and interest-bearing liabilities. Interest rate risk and liquidity risk management is performed at the Bank level. Although the Bank has a diversified loan portfolio, loans outstanding to individuals and businesses depend upon the local economic conditions in the immediate trade area.

One of the primary functions of the Corporation's asset/liability management committee is to monitor the level to which the balance sheet is subject to interest rate risk. The goal of the asset/liability committee is to manage the relationship between interest rate sensitive assets and liabilities, thereby minimizing the fluctuations in the net interest margin, which achieves consistent growth of net interest income during periods of changing interest rates.

Interest rate sensitivity is the result of differences in the amounts and repricing dates of the Bank's rate sensitive assets and rate sensitive liabilities. These differences, or interest rate repricing "gap", provide an indication of the extent that the Corporation's net interest income is affected by future changes in interest rates. A gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities and is considered negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. Generally, during a period of rising interest rates, a negative gap would adversely affect net interest income while a positive gap would result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would result in an increase in net interest income and a positive gap would adversely affect net interest income. The closer to zero that gap is maintained, generally, the lesser the impact of market interest rate changes on net interest income.

Assumptions about the timing and variability of cash flows are critical in gap analysis. Particularly important are the assumptions driving mortgage prepayments and the expected attrition of the core deposits portfolios. These assumptions are based on the Corporation's historical experience, industry standards and assumptions provided by a federal regulatory agency, which management believes most accurately represents the sensitivity of the Corporation's assets and liabilities to interest rate changes. As of June 30, 2013, the Corporation's interest-earning assets maturing or repricing within one year totaled \$153.5 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$161.6 million, providing an excess of interest-bearing liabilities over interest-earning assets of \$8.1 million. At June 30, 2013, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 95.0%.

For more information, see “Market Risk Management” in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2012.

**Item 4. Controls and Procedures**

The Corporation maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Corporation’s Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to the Corporation’s management, including its Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as appropriate, to allow timely decisions regarding required disclosure based on the definition of “disclosure controls and procedures” in Rule 13a-15(e).

As of June 30, 2013, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation’s management, including the Corporation’s CEO and CFO, of the effectiveness of the design and operation of the Corporation’s disclosure controls and procedures. Based on the foregoing, the Corporation’s CEO and CFO concluded that the Corporation’s disclosure controls and procedures were effective. There have been no significant changes in the Corporation’s internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Corporation completed its evaluation.

There has been no change made in the Corporation's internal control over financial reporting during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

The Corporation is involved in various legal proceedings occurring in the ordinary course of business. It is the opinion of management, after consultation with legal counsel, that these matters will not materially affect the Corporation's consolidated financial position or results of operations.

### **Item 1A. Risk Factors**

There have been no material changes from those risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2012, as filed with the Securities and Exchange Commission. Additional risks not presently known to us, or that we currently deem immaterial, may also adversely affect our business, financial condition or results of operations.

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

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

(a) Not applicable.

(b) Not applicable.

**Item 6. Exhibits**

**Exhibit 31.1** Rule 13a-14(a) Certification of Principal Executive Officer

**Exhibit 31.2** Rule 13a-14(a) Certification of Principal Financial Officer

**Exhibit 32.1** CEO Certification Pursuant to 18 U.S.C. Section 1350

**Exhibit 32.2** CFO Certification Pursuant to 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 Definitions Linkbase Document\*

**101.LAB** XBRL Taxonomy Extension Label Linkbase Document\*

**101.PRE** XBRL Taxonomy Extension Presentation Linkbase Document\*

These interactive data files shall not be deemed filed for purposes of Section 11 or 12 of the Securities Act of 1933, \*as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.

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**Signatures**

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

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Date: August 12, 2013 By: /s/ William C. Marsh  
William C. Marsh  
Chairman of the Board,  
President and Chief  
Executive Officer

Date: August 12, 2013 By: /s/ Matthew J. Lucco  
Matthew J. Lucco  
Chief Financial Officer  
Treasurer