

BAR HARBOR BANKSHARES  
Form 10-Q  
May 09, 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 March 31, 2013**

**OR**

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

Commission File Number: **01-13349**

**BAR HARBOR BANKSHARES**

(Exact name of registrant as specified in its charter)

**Maine**  
(State or other jurisdiction of  
incorporation or organization)

**01-0393663**  
(I.R.S. Employer  
Identification Number)

**PO Box 400**  
**82 Main Street, Bar Harbor, ME**  
(Address of principal executive offices)

**04609-0400**  
(Zip Code)

**(207) 288-3314**

(Registrant's telephone number, including area code)

**Inapplicable**

(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. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act: Large accelerated filer  Accelerated filer  Non-accelerated filer (do not check if a smaller reporting company)  Smaller reporting company

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

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

| <u>Class of Common Stock</u> | <u>Number of Shares Outstanding</u> <u>May 1, 2013</u> |
|------------------------------|--|
| \$2.00 Par Value             | 3,928,149  |

**TABLE OF CONTENTS**

**PART I FINANCIAL INFORMATION**

Item 1. Interim Financial Statements (*unaudited*):

**Page  
No.**

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|   |       |
|---|-------|
| Consolidated Balance Sheets at March 31, 2013, and December 31, 2012  | 3     |
| Consolidated Statements of Income for the three months ended March 31, 2013 and 2012                          | 4     |
| Consolidated Statements of Comprehensive Income for the three months ended March 31, 2013 and 2012            | 5     |
| Consolidated Statements of Changes in Shareholders' Equity for the three months ended March 31, 2013 and 2012 | 6     |
| Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and 2012                      | 7     |
| Notes to Consolidated Interim Financial Statements  | 8-32  |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations                 | 32-56 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk  | 56-59 |
| Item 4. Controls and Procedures   | 59    |
| <b>PART II OTHER INFORMATION</b>  |       |
| Item 1. Legal Proceedings   | 59    |
| Item 1A. Risk Factors   | 60    |
| Item 6. Exhibits  | 60    |
| Signatures  | 60    |
| Exhibit Index   | 61    |
| Exhibits  |       |

**PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****BAR HARBOR BANKSHARES AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****MARCH 31, 2013 AND DECEMBER 31, 2012****(Dollars in thousands, except share and per share data)***(unaudited)*

|  | <b>March 31,</b>   | <b>December 31,</b> |
|--|--------------------|---------------------|
|  | <b>2013</b>        | <b>2012</b>         |
| Assets   |                    |                     |
| Cash and cash equivalents  | 10,305             | 14,992              |
| Securities available for sale, at fair value (amortized cost of \$415,023 and \$405,769, respectively)                         | 423,914            | 418,040             |
| Federal Home Loan Bank stock   | 18,108             | 18,189              |
| Loans  | 817,226            | 815,004             |
| Allowance for loan losses  | (8,055)            | (8,097)             |
| Loans, net of allowance for loan losses  | 809,171            | 806,907             |
| Premises and equipment, net  | 19,683             | 19,255              |
| Goodwill   | 4,935              | 4,935               |
| Bank owned life insurance  | 7,695              | 7,633               |
| Other assets   | 13,441             | 12,984              |
| <b>TOTAL ASSETS</b>  | <b>\$1,307,252</b> | <b>\$1,302,935</b>  |
| Liabilities  |                    |                     |
| Deposits:  |                    |                     |
| Demand and other non-interest bearing deposits   | \$ 62,984          | \$ 71,865           |
| NOW accounts   | 115,686            | 123,015             |
| Savings and money market deposits  | 222,513            | 230,325             |
| Time deposits  | 399,917            | 370,560             |
| Total deposits   | 801,100            | 795,765             |
| Short-term borrowings  | 224,673            | 224,077             |
| Long-term advances from Federal Home Loan Bank   | 141,990            | 142,490             |
| Junior subordinated debentures   | 5,000              | 5,000               |
| Other liabilities  | 6,437              | 7,557               |
| <b>TOTAL LIABILITIES</b>   | <b>1,179,200</b>   | <b>1,174,889</b>    |
| Shareholders' equity   |                    |                     |
| Capital stock, par value \$2.00; authorized 10,000,000 shares; issued 4,525,635 shares at March 31, 2013 and December 31, 2012 | 9,051              | 9,051               |

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|   |             |             |
|---|-------------|-------------|
| Surplus   | 26,719      | 26,693      |
| Retained earnings   | 95,901      | 93,900      |
| Accumulated other comprehensive income:   |             |             |
| Prior service cost and unamortized net actuarial losses on employee benefit plans, net of tax of (\$230) and (\$207), at March 31, 2013 and December 31, 2012, respectively | (447)       | (401)       |
| Net unrealized appreciation on securities available for sale, net of tax of \$2,874 and \$4,099, at March 31, 2013 and December 31, 2012, respectively                      | 5,578       | 7,954       |
| Portion of OTTI attributable to non-credit gains, net of tax of \$152 and \$74, at March 31, 2013 and December 31, 2012, respectively                                       | 290         | 144         |
| Total accumulated other comprehensive income  | 5,421       | 7,697       |
| Less: cost of 597,486 and 605,591 shares of treasury stock at March 31, 2013 and December 31, 2012, respectively  | (9,040)     | (9,295)     |
| TOTAL SHAREHOLDERS' EQUITY  | 128,052     | 128,046     |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY  | \$1,307,252 | \$1,302,935 |

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements.*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****FOR THE THREE MONTHS ENDED MARCH 31, 2013 AND 2012****(Dollars in thousands, except per share data)***(unaudited)*

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2013</b>               | <b>2012</b> |
| Interest and dividend income:                         |                           |             |
| Interest and fees on loans                            | \$ 9,181                  | \$8,878     |
| Interest on securities                                | 3,162                     | 3,689       |
| Dividend on FHLB stock                                | 22                        | 20          |
| Total interest and dividend income                    | 12,365                    | 12,587      |
| Interest expense:                                     |                           |             |
| Deposits  | 1,702                     | 1,955       |
| Short-term borrowings                                 | 128                       | 95          |
| Long-term debt  | 1,246                     | 1,520       |
| Total interest expense                                | 3,076                     | 3,570       |
| Net interest income                                   | 9,289                     | 9,017       |
| Provision for loan losses                             | 353                       | 415         |
| Net interest income after provision for loan losses   | 8,936                     | 8,602       |
| Non-interest income:                                  |                           |             |
| Trust and other financial services                    | 906                       | 779         |
| Service charges on deposit accounts                   | 295                       | 250         |
| Credit and debit card service charges and fees        | 336                       | 316         |
| Net securities gains                                  | 265                       | 567         |
| Total other-than-temporary impairment ("OTTI") losses | ---                       | (458)       |
| Non-credit portion of OTTI losses (before taxes) (1)  | ---                       | 114         |
| Net OTTI losses recognized in earnings                | ---                       | (344)       |
| Other operating income                                | 148                       | 132         |
| Total non-interest income                             | 1,950                     | 1,700       |
| Non-interest expense:                                 |                           |             |
| Salaries and employee benefits                        | 3,607                     | 3,182       |
| Occupancy expense                                     | 484                       | 405         |
| Furniture and equipment expense                       | 510                       | 415         |
| Credit and debit card expenses                        | 96                        | 88          |
| FDIC insurance assessments                            | 196                       | 185         |
| Other operating expense                               | 1,414                     | 1,533       |
| Total non-interest expense                            | 6,307                     | 5,808       |

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|                                      |          |          |
|--------------------------------------|----------|----------|
| Income before income taxes           | 4,579    | 4,494    |
| Income taxes                         | 1,363    | 1,331    |
| Net income                           | \$ 3,216 | \$ 3,163 |
| <b><u>Per Common Share Data:</u></b> |          |          |
| Basic earnings per share             | \$ 0.82  | \$ 0.82  |
| Diluted earnings per share           | \$ 0.82  | \$ 0.81  |

(1)

*Included in other comprehensive loss, net of tax*

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements.*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****FOR THE THREE MONTHS ENDED MARCH 31, 2013 AND 2012****(Dollars in thousands)***(unaudited)*

|   | <b>THREE MONTHS<br/>ENDED</b> |             |
|---|-------------------------------|-------------|
|   | <b>MARCH 31,</b>              |             |
|   | <b>2013</b>                   | <b>2012</b> |
| Net income  | \$3,216                       | \$3,163     |
| Other comprehensive income:   |                               |             |
| Net unrealized (depreciation) appreciation on securities  |                               |             |
| available for sale, net of tax of (\$1,060) and \$316, respectively                                 | (2,057)                       | 612         |
| Less reclassification adjustment for net gains related to securities                                |                               |             |
| available for sale included in net income, net of tax of (\$90) and (\$193), respectively           | (175)                         | (374)       |
| Add other-than-temporary impairment adjustment, net of tax of \$0 and \$156, respectively           | ---                           | 302         |
| Less non-credit portion of other-than-temporary impairment losses,                                  |                               |             |
| net of tax of \$0 and (\$39), respectively  | ---                           | (75)        |
| Net amortization of prior service cost and actuarial (gain) loss for                                |                               |             |
| supplemental executive retirement plan, net of related tax of (\$28) and \$0, respectively          | (54)                          | ---         |
| Actuarial loss (gain) on supplemental executive retirement plan, net of related tax of \$5 and \$0, |                               |             |
| respectively  | 10                            | ---         |
| Total other comprehensive (loss) income   | (2,276)                       | 465         |
| Total comprehensive income  | \$ 940                        | \$3,628     |

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements*



## BAR HARBOR BANKSHARES AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

FOR THE THREE MONTHS ENDED MARCH 31, 2013 AND 2012

(Dollars in thousands, except share and per share data)

(unaudited)

|   | Accumulated |           |                   |                             |                | Total     |                      |
|---|-------------|-----------|-------------------|-----------------------------|----------------|-----------|----------------------|
|   | Capital     |           | Retained Earnings | Comprehensive income (loss) | Treasury Stock |           | Shareholders' Equity |
|   | Stock       | Surplus   |                   |                             |                |           |                      |
| <b>Balance December 31, 2011</b>                | \$9,051     | \$ 26,512 | \$86,198          | \$ 7,024                    | \$(10,535)     | \$118,250 |                      |
| Net income                                      | ---         | ---       | 3,163             | ---                         | ---            | 3,163     |                      |
| Total other comprehensive income                | ---         | ---       | ---               | 465                         | ---            | 465       |                      |
| Dividend declared:                              |             |           |                   |                             |                |           |                      |
| Common stock (\$0.285 per share)                | ---         | ---       | (1,106)           | ---                         | ---            | (1,106)   |                      |
| Stock options exercised (3,482 shares),         |             |           |                   |                             |                |           |                      |
| including related tax effects                   | ---         | 2         | (24)              | ---                         | 98             | 76        |                      |
| Recognition of stock based compensation expense |             | 30        | ---               | ---                         | ---            | 30        |                      |
| <b>Balance March 31, 2012</b>                   | \$9,051     | \$26,544  | \$88,231          | \$ 7,489                    | \$(10,437)     | \$120,878 |                      |
| <b>Balance December 31, 2012</b>                | \$9,051     | \$26,693  | \$93,900          | \$ 7,697                    | \$ (9,295)     | \$128,046 |                      |
| Net income                                      | ---         | ---       | 3,216             | ---                         | ---            | 3,216     |                      |
| Total other comprehensive loss                  | ---         | ---       | ---               | (2,276)                     | ---            | (2,276)   |                      |
| Dividend declared:                              |             |           |                   |                             |                |           |                      |
| Common stock (\$0.305 per share)                | ---         | ---       | (1,196)           | ---                         | ---            | (1,196)   |                      |
| Stock options exercised (5,429 shares),         |             |           |                   |                             |                |           |                      |
| including related tax effects                   | ---         | ---       | (30)              | ---                         | 171            | 141       |                      |
| Recognition of stock based compensation expense |             | 121       | ---               | ---                         | ---            | 121       |                      |
| Restricted stock grants (2,676 shares)          | ---         | (95)      | 11                | ---                         | 84             | ---       |                      |
| <b>Balance March 31, 2013</b>                   | \$9,051     | \$26,719  | \$95,901          | \$ 5,421                    | \$ (9,040)     | \$128,052 |                      |

The accompanying notes are an integral part of these unaudited consolidated interim financial statements.



**BAR HARBOR BANKSHARES AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE THREE MONTHS ENDED MARCH 31, 2013 AND 2012****(Dollars in thousands)***(unaudited)*

|   | <b>2013</b> | <b>2012</b> |
|---|-------------|-------------|
| Cash flows from operating activities:   |             |             |
| Net income  | \$ 3,216    | \$ 3,163    |
| Adjustments to reconcile net income to net cash provided by operating activities:               |             |             |
| Depreciation and amortization of premises and equipment   | 342         | 298         |
| Amortization of core deposit intangible   | (56)        | ---         |
| Provision for loan losses   | 353         | 415         |
| Net securities gains  | (265)       | (567)       |
| Other-than-temporary impairment   | ---         | 344         |
| Net amortization of bond premiums and discounts   | 1,333       | 701         |
| Recognition of stock based expense  | 121         | 30          |
| Net change in other assets  | 609         | (190)       |
| Net change in other liabilities   | (1,120)     | (292)       |
| Net cash provided by operating activities   | 4,533       | 3,902       |
| Cash flows from investing activities:   |             |             |
| Purchases of securities available for sale  | (40,970)    | (44,991)    |
| Proceeds from maturities, calls and principal paydowns of mortgage-backed securities            | 25,611      | 19,334      |
| Proceeds from sales of securities available for sale  | 5,038       | 11,073      |
| Net (decrease) increase in Federal Home Loan Bank stock   | 81          | (643)       |
| Net loans made to customers   | (2,586)     | (35,495)    |
| Proceeds from sale of other real estate owned   | ---         | 45          |
| Capital expenditures  | (770)       | (1,643)     |
| Net cash used in investing activities   | (13,596)    | (52,320)    |
| Cash flows from financing activities:   |             |             |
| Net increase in deposits  | 5,335       | 1,549       |
| Net (decrease ) increase in securities sold under repurchase agreements and fed funds purchased | (3,036)     | 5,932       |
| Proceeds from Federal Home Loan Bank advances   | 13,200      | 67,500      |
| Repayments of Federal Home Loan Bank advances   | (10,068)    | (20,112)    |
| Proceeds from stock option exercises, including excess tax benefits                             | 141         | 76          |
| Payments of dividends   | (1,196)     | (1,106)     |
| Net cash provided by financing activities   | 4,376       | 53,839      |
| Net (decrease) increase in cash and cash equivalents  | (4,687)     | 5,421       |
| Cash and cash equivalents at beginning of period  | 14,992      | 8,720       |

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|  |          |          |
|--|----------|----------|
| Cash and cash equivalents at end of period         | \$10,305 | \$14,141 |
| Supplemental disclosures of cash flow information: |          |          |
| Cash paid during the period for:                   |          |          |
| Interest   | \$ 3,071 | \$ 3,620 |
| Income taxes                                       | ---      | 46       |
| Schedule of noncash investing activities:          |          |          |
| Transfers from loans to other real estate owned    | \$ 31    | \$ 343   |

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements.*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**MARCH 31, 2013**

**(Dollars in thousands, except share and per share data)**

*(unaudited)*

**Note 1: Basis of Presentation**

The accompanying consolidated interim financial statements are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All inter-company transactions have been eliminated in consolidation. Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation. The net income reported for the three months ended March 31, 2013, is not necessarily indicative of the results that may be expected for the year ending December 31, 2013, or any other interim periods.

The consolidated balance sheet at December 31, 2012, has been derived from audited consolidated financial statements at that date. The accompanying unaudited interim consolidated financial statements have been prepared in accordance with United States ( U.S. ) generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X (17 CFR Part 210). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, please refer to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012, and notes thereto.

**Note 2: Management s Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. 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, other-than-temporary impairments on securities, income tax estimates, and the valuation of intangible assets.

***Allowance for Loan Losses:*** The allowance for loan losses (the allowance ) is a significant accounting estimate used in the preparation of the Company's consolidated financial statements. The allowance is available to absorb losses on loans and is maintained at a level that, in management's judgment, is appropriate for the amount of risk inherent in the loan portfolio, given past and present conditions. The allowance is increased by provisions charged to operating expense and by recoveries on loans previously charged-off, and is decreased by loans charged-off as uncollectible.

Arriving at an appropriate level of allowance involves a high degree of judgment. The determination of the adequacy of the allowance and provisioning for estimated losses is evaluated regularly based on review of loans, with particular emphasis on non-performing or other loans that management believes warrant special consideration. The ongoing evaluation process includes a formal analysis, which considers among other factors: the character and size of the loan portfolio, business and economic conditions, real estate market conditions, collateral values, changes in product offerings or loan terms, changes in underwriting and/or collection policies, loan growth, previous charge-off experience, delinquency trends, non-performing loan trends, the performance of individual loans in relation to contract terms, and estimated fair values of collateral.

The allowance consists of allowances established for specific loans including impaired loans; allowances for pools of loans based on historical charge-offs by loan types; and supplemental allowances that adjust historical loss experience to reflect current economic conditions, industry specific risks, and other observable data.

While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers may necessitate future additions or reductions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowance, which also may necessitate future additions or reductions to the allowance, based on information available to them at the time of their examination.

***Other-Than-Temporary Impairments on Investment Securities:*** One of the significant estimates relating to securities is the evaluation of other-than-temporary impairment. If a decline in the fair value of a security is judged to be other-than-temporary, and management does not intend to sell the security and believes it is more-likely-than-not the Company will not be required to sell the security prior to recovery of cost or amortized cost, the portion of the total impairment attributable to the credit loss is recognized in earnings, and the remaining difference between the security's amortized cost basis and its fair value is included in other comprehensive income.

For impaired available for sale debt securities that management intends to sell, or where management believes it is more-likely-than-not that the Company will be required to sell, an other-than-temporary impairment charge is recognized in earnings equal to the difference between fair value and cost or amortized cost basis of the security. The fair value of the other-than-temporarily impaired security becomes its new cost basis.

The evaluation of securities for impairments is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of securities should be recognized in current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition and/or future prospects, the effects of changes in interest rates or credit spreads and the expected recovery period of unrealized losses. The Company has a security monitoring process that identifies securities that, due to certain characteristics, as described below, are subjected to an enhanced analysis on a quarterly basis.

Securities that are in an unrealized loss position, are reviewed at least quarterly to determine if an other-than-temporary impairment is present based on certain quantitative and qualitative factors and measures. The primary factors considered in evaluating whether a decline in value of securities is other-than-temporary include: (a) the cause of the impairment; (b) the financial condition, credit rating and future prospects of the issuer; (c) whether the debtor is current on contractually obligated interest and principal payments; (d) the volatility of the securities' fair value; (e) performance indicators of the underlying assets in the security including default rates, delinquency rates, percentage of non-performing assets, loan to collateral value ratios, conditional payment rates, third party guarantees, current levels of subordination, vintage, and geographic concentration and; (f) any other information and observable data considered relevant in determining whether other-than-temporary impairment has occurred, including the expectation of the receipt of all principal and interest due.

In addition, for securitized financial assets with contractual cash flows, such as private label mortgage-backed securities, the Company periodically updates its best estimate of cash flows over the life of the security. The Company's best estimate of cash flows is based upon assumptions consistent with the current economic environment, similar to those the Company believes market participants would use. If the fair value of a securitized financial asset is less than its cost or amortized cost and there has been an adverse change in timing or amount of anticipated future cash flows since the last revised estimate to the extent that the Company does not expect to receive the entire amount of future contractual principal and interest, an other-than-temporary impairment charge is recognized in earnings representing the estimated

credit loss if management does not intend to sell the security and believes it is more-likely-than-not the Company will not be required to sell the security prior to recovery of cost or amortized cost. Estimating future cash flows is a quantitative and qualitative process that incorporates information received from third party sources along with certain assumptions and judgments regarding the future performance of the underlying collateral. In addition, projections of expected future cash flows may change based upon new information regarding the performance of the underlying collateral.

**Income Taxes:** The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. If current available information indicates that it is more-likely-than-not that deferred tax assets will not be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Significant management judgment is required in determining income tax expense and deferred tax assets and liabilities. As of March 31, 2013, and December 31, 2012, there was no valuation allowance for deferred tax assets. Deferred tax assets are included in other assets on the consolidated balance sheet.

**Goodwill and Identifiable Intangible Assets:** In connection with acquisitions, the Company generally records assets on its consolidated financial statements both goodwill and identifiable intangible assets, such as core deposit intangibles.

The Company evaluates whether the carrying value of its goodwill has become impaired, in which case the value is reduced through a charge to its earnings. Goodwill is evaluated for impairment at least annually, or upon a triggering event using certain fair value techniques. Goodwill impairment testing is performed at the segment (or reporting unit) level. Goodwill is assigned to reporting units at the date the goodwill is initially recorded. Once goodwill has been assigned to the reporting units, it no longer retains its association with a particular acquisition, and all of the activities within a reporting unit, whether acquired or organically grown, are available to support the value of the goodwill.

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. The Company completes its annual goodwill impairment test as of December 31 of each year. The impairment testing process is conducted by assigning assets and goodwill to each reporting unit. Currently, the Company's goodwill is evaluated at the entity level as there is only one reporting unit. The Company first assesses certain qualitative factors to determine if it is more likely than not that the fair value of the reporting unit is less than its carrying value. If it is more likely than not that the fair value of the reporting unit is less than the carrying value, then the fair value of each reporting unit is compared to the recorded book value - step one. If the fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and step two is not considered necessary. If the carrying value of a reporting unit exceeds its fair value, the impairment test continues (step two) by comparing the carrying value of the reporting unit's goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill.

An impairment charge is recognized if the carrying fair value of goodwill exceeds the implied fair value of goodwill. At December 31, 2012, there was no indication of impairment that led the Company to believe it needed to perform a two-step test.

Any changes in the estimates used by the Company to determine the carrying value of its goodwill, or which otherwise adversely affect their value or estimated lives, would adversely affect the Company's consolidated results of operations.

### Note 3: Business Combinations

On August 10, 2012, Bar Harbor Bank & Trust (the Bank), a wholly-owned first tier operating subsidiary of Bar Harbor Bankshares, completed its acquisition of the operations of the Border Trust Company (Border Trust), a state chartered bank headquartered in Augusta, Maine, by acquiring certain assets and assuming certain liabilities, including all deposits for a net purchase price of \$133. This transaction represented a strategic extension of the Company's franchise with three branch locations located in Kennebec and Sagadahoc counties.

The Company has determined that the acquisition of the net assets of Border Trust constituted a business combination as defined by the FASB ASC Topic 805, *Business Combinations*. Accordingly, the assets acquired and liabilities assumed were recorded at their fair values. Fair values were determined based on the requirements of FASB ASC Topic 820, *Fair Value Measurements*. In many cases, the determination of these fair values required management to make estimates about discount rates, future expected cash flows, market conditions and other future events that are highly subjective in nature and subject to change. These fair value estimates are subject to change for up to one year after the closing date of the transaction as additional information relative to closing date fair values becomes available. In addition, the tax treatment is complex and subject to interpretations that may result in future adjustments of deferred taxes as of the acquisition date.

The results of Border Trust's operations are included in the Consolidated Statements of Income from the date of acquisition. In connection with this transaction, the consideration paid, the assets acquired, and the liabilities assumed were recorded at fair value on the date of acquisition, as summarized in the following table, as of August 10, 2012.

|  |         |
|--|---------|
| <b>Fair value of total consideration paid:</b>     |         |
| Cash consideration paid at closing to Border Trust | \$ 133  |
| <b>Fair value of identifiable assets acquired:</b> |         |
| Cash and cash equivalents                          | \$1,330 |
| Securities   | 3,537   |
| Federal Home Loan Bank Common stock                | 770     |
| Loans  | 33,606  |
| Premises and equipment                             | 563     |
| Core deposit intangible                            | 783     |
| Other assets                                       | 540     |
| Total identifiable assets acquired                 | 41,129  |
| <b>Fair value of liabilities assumed:</b>          |         |
| Deposits   | 38,520  |

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|   |                |
|---|----------------|
| Borrowings  | 3,776          |
| Other liabilities                                     | 477            |
| Total liabilities assumed                             | 42,773         |
| <b>Fair value of net identifiable assets acquired</b> | <b>1,644</b>   |
| <b>Goodwill resulting from transaction</b>            | <b>\$1,777</b> |

Initial goodwill of \$1,777 was recorded after adjusting for the fair value of net identifiable assets acquired. The estimated goodwill from the acquisition represents the inherent long-term value anticipated from the synergies and business opportunities expected to be achieved as a result of the transaction. The estimated core deposit intangible asset is being amortized over its estimated life, currently expected to be eight and one-half years.

#### Note 4: Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company, such as the Company's dilutive stock options.

The following is a reconciliation of basic and diluted earnings per share for the three months ended March 31, 2013, and 2012:

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2013</b>               | <b>2012</b> |
| Net income available to common shareholders                        | \$ 3,216                  | \$ 3,163    |
| Weighted average common shares outstanding                         |                           |             |
| Basic  | 3,923,719                 | 3,880,052   |
| Effect of dilutive employee stock options                          | 17,653                    | 11,656      |
| Diluted  | 3,941,372                 | 3,891,708   |
| Anti-dilutive options excluded from earnings per share calculation | 38,500                    | 84,442      |
| <b><u>Per Common Share Data:</u></b>                               |                           |             |
| Basic earnings per share   | \$ 0.82                   | \$ 0.82     |
| Diluted earnings per share   | \$ 0.82                   | \$ 0.81     |



**Note 5: Securities Available For Sale**

The following tables summarize the securities available for sale portfolio as of March 31, 2013, and December 31, 2012:

| <b>March 31, 2013</b>               | <b>Gross</b>     | <b>Gross</b>      |                   |                   |
|-------------------------------------|------------------|-------------------|-------------------|-------------------|
|                                     | <b>Amortized</b> | <b>Unrealized</b> | <b>Unrealized</b> | <b>Estimated</b>  |
| <b>Available for Sale:</b>          | <b>Cost</b>      | <b>Gains</b>      | <b>Losses</b>     | <b>Fair Value</b> |
| Mortgage-backed securities:         |                  |                   |                   |                   |
| US Government-sponsored enterprises | \$244,075        | \$ 7,008          | \$2,149           | \$248,934         |
| US Government agency                | 87,716           | 1,810             | 259               | 89,267            |
| Private label                       | 7,416            | 733               | 275               | 7,874             |
| Obligations of states and political |                  |                   |                   |                   |
| subdivisions thereof                | 75,816           | 2,932             | 909               | 77,839            |
| Total                               | \$415,023        | \$12,483          | \$3,592           | \$423,914         |

| December 31, 2012  |                  | Gross           | Gross          |                   |
|--|------------------|-----------------|----------------|-------------------|
|  | Amortized        | Unrealized      | Unrealized     | Estimated         |
| <b>Available for Sale:</b>                               | <b>Cost</b>      | <b>Gains</b>    | <b>Losses</b>  | <b>Fair Value</b> |
| Mortgage-backed securities:                              |                  |                 |                |                   |
| US Government-sponsored enterprises                      | \$238,974        | \$ 7,913        | \$1,064        | \$245,823         |
| US Government agency                                     | 82,397           | 2,080           | 216            | 84,261            |
| Private label  | 8,063            | 571             | 521            | 8,113             |
| Obligations of states and political subdivisions thereof | 76,335           | 4,040           | 532            | 79,843            |
| <b>Total</b>   | <b>\$405,769</b> | <b>\$14,604</b> | <b>\$2,333</b> | <b>\$418,040</b>  |

**Securities Maturity Distribution:** The following table summarizes the maturity distribution of the amortized cost and estimated fair value of securities available for sale as of March 31, 2013. Actual maturities may differ from the final maturities noted below because issuers may have the right to prepay or call certain securities. In the case of mortgage-backed securities, actual maturities may also differ from expected maturities due to the amortizing nature of the underlying mortgage collateral, and the fact that borrowers have the right to prepay.

|  | Amortized        | Estimated         |
|--|------------------|-------------------|
| <b>Securities Available for Sale</b>   | <b>Cost</b>      | <b>Fair Value</b> |
| Due one year or less                   | \$ 11            | \$ 11             |
| Due after one year through five years  | 8,016            | 8,194             |
| Due after five years through ten years | 19,148           | 20,455            |
| Due after ten years                    | 387,848          | 395,254           |
|  | <b>\$415,023</b> | <b>\$423,914</b>  |

**Securities Impairment:** As a part of the Company's ongoing security monitoring process, the Company identifies securities in an unrealized loss position that could potentially be other-than-temporarily impaired ( OTTI ).

For the three months ended March 31, 2013, the Company did not have any net OTTI losses recognized in earnings (before taxes), compared with \$344 in the first quarter of 2012. The OTTI losses recognized in earnings during the three months ended March 31, 2012 represented management's best estimate of credit losses inherent in the securities based on discounted, bond-specific future cash flow projections using assumptions about cash flows associated with the pools of mortgage loans underlying each security. In estimating those cash flows the Company takes a variety of factors into consideration including, but not limited to, loan level credit characteristics, current delinquency and non-performing loan rates, current levels of subordination and credit support, recent default rates and future constant default rate estimates, original and current loan to collateral value ratios, recent collateral loss severities and future collateral loss severity estimates, recent and historical conditional prepayment rates and future conditional prepayment

rate assumptions, and other estimates of future collateral performance.

Despite the levels of delinquencies, defaults and losses in the underlying residential mortgage loan collateral, given credit enhancements resulting from the structures of the individual securities, the Company currently expects that as of March 31, 2013, it will recover the amortized cost basis of its private label mortgage-backed securities as depicted in the table below and has therefore concluded that such securities were not other-than-temporarily impaired as of that date. Nevertheless, given recent market conditions, it is possible that adverse changes in repayment performance and fair value could occur in future periods that could impact the Company's current best estimates.

The following table displays the beginning balance of OTTI related to historical credit losses on debt securities held by the Company at the beginning of the current reporting period, as well as changes in credit losses recognized in pre-tax earnings for the three months ending March 31, 2013, and 2012.

|  | <b>2013</b>    | <b>2012</b>    |
|--|----------------|----------------|
| <b>Estimated credit losses as of prior year-end,</b> | \$5,131        | \$4,697        |
| Additions for credit losses for securities on which  |                |                |
| OTTI has been previously recognized                  | ---            | 310            |
| Additions for credit losses for securities on which  |                |                |
| OTTI has not been previously recognized              | ---            | 34             |
| Reductions for securities paid off during the period | 691            | ---            |
| <b>Estimated credit losses as of March 31,</b>       | <b>\$4,440</b> | <b>\$5,041</b> |

Upon initial impairment of a security, total OTTI losses represent the excess of the amortized cost over the fair value. For subsequent impairments of the same security, total OTTI losses represent additional credit losses and or declines in fair value subsequent to the previously recorded OTTI losses, if applicable. Unrealized OTTI losses recognized in accumulated other comprehensive income (OCI) represent the non-credit component of OTTI losses on debt securities. Net impairment losses recognized in earnings represent the credit component of OTTI losses on debt securities.

As of March 31, 2013, the Company held fourteen private-label MBS (debt securities) with a total amortized cost (i.e. carrying value) of \$3,745 for which OTTI losses have previously been recognized in pre-tax earnings (dating back to the fourth quarter of 2008). For eleven of these securities, the Company previously recognized credit losses in excess of the unrealized losses in accumulated OCI, creating an unrealized gain of \$442, net of tax, as included in accumulated OCI as of March 31, 2013. For the remaining three securities, the total OTTI losses included in accumulated OCI amounted to \$152, net of tax, as of March 31, 2013. As of March 31, 2013, the total net unrealized gains included in accumulated OCI for securities held where OTTI has been historically recognized in pre-tax earnings amounted to \$290, net of tax, compared with net unrealized gains of \$144, net of tax, at December 31, 2012.

As of March 31, 2013, based on a review of each of the remaining securities in the securities portfolio, the Company concluded that it expects to recover its amortized cost basis for such securities. This conclusion was based on the issuers' continued satisfaction of the securities obligations in accordance with their contractual terms and the expectation that they will continue to do so through the maturity of the security, the expectation that the Company will receive the entire amount of future contractual cash flows, as well as the evaluation of the fundamentals of the issuers' financial condition and other objective evidence. Accordingly, the Company concluded that the declines in the values of those securities were temporary and that any additional other-than-temporary impairment charges were not appropriate at March 31, 2013. As of that date, the Company did not intend to sell nor anticipated that it would more-likely-than-not be required to sell any of its impaired securities, that is, where fair value is less than the cost basis of the security.

The following table summarizes the fair value of securities with continuous unrealized losses for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer as of March 31, 2013 and December 31, 2012. All securities referenced are debt securities. At March 31, 2013, and December 31, 2012, the Company did not hold any common stock or other equity securities in its securities portfolio.

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| March 31, 2013   | Less than 12 months |                       |                   | 12 months or longer |                       |                   | Total      |                       |                   |
|--|---------------------|-----------------------|-------------------|---------------------|-----------------------|-------------------|------------|-----------------------|-------------------|
|  | Estimated           |                       |                   | Estimated           |                       |                   | Estimated  |                       |                   |
|  | Fair Value          | Number of Investments | Unrealized Losses | Fair Value          | Number of Investments | Unrealized Losses | Fair Value | Number of Investments | Unrealized Losses |
| <b>Description of Securities:</b>                                      |                     |                       |                   |                     |                       |                   |            |                       |                   |
| Mortgage-backed securities:  |                     |                       |                   |                     |                       |                   |            |                       |                   |
| US Government-sponsored enterprises                                    | \$ 66,787           | 70                    | \$2,135           | \$1,468             | 2                     | \$ 14             | \$ 68,255  | 72                    | \$2,149           |
| US Government agency   | 22,111              | 23                    | 259               | 50                  | 2                     | ---               | 22,161     | 25                    | 259               |
| Private label Obligations of states and political subdivisions thereof | 46                  | 3                     | 16                | 1,426               | 11                    | 259               | 1,472      | 14                    | 275               |
| Total  | \$109,784           | 148                   | \$2,974           | \$6,010             | 28                    | \$618             | \$115,794  | 176                   | \$3,592           |

| December 31, 2012                   | Less than 12 months |                       |                   | 12 months or longer |                       |                   | Total      |                       |                   |
|-------------------------------------|---------------------|-----------------------|-------------------|---------------------|-----------------------|-------------------|------------|-----------------------|-------------------|
|                                     | Estimated           |                       |                   | Estimated           |                       |                   | Estimated  |                       |                   |
|                                     | Fair Value          | Number of Investments | Unrealized Losses | Fair Value          | Number of Investments | Unrealized Losses | Fair Value | Number of Investments | Unrealized Losses |
| <b>Description of Securities:</b>   |                     |                       |                   |                     |                       |                   |            |                       |                   |
| Mortgage-backed securities:         |                     |                       |                   |                     |                       |                   |            |                       |                   |
| US Government-sponsored enterprises | \$ 56,008           | 55                    | \$1,064           | \$ ---              | ---                   | \$ ---            | \$ 56,008  | 55                    | \$1,064           |
| US Government                       | 15,281              | 18                    | 216               | 56                  | 2                     | ---               | 15,337     | 20                    | 216               |

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|                |           |     |         |         |    |       |           |     |         |
|----------------|-----------|-----|---------|---------|----|-------|-----------|-----|---------|
| agency         |           |     |         |         |    |       |           |     |         |
| Private label  | 783       | 6   | 48      | 2,196   | 14 | 473   | 2,979     | 20  | 521     |
| Obligations of |           |     |         |         |    |       |           |     |         |
| states         |           |     |         |         |    |       |           |     |         |
| and political  |           |     |         |         |    |       |           |     |         |
| subdivisions   |           |     |         |         |    |       |           |     |         |
| thereof        | 10,476    | 27  | 261     | 2,561   | 12 | 271   | 13,037    | 39  | 532     |
| Total          | \$ 82,548 | 106 | \$1,589 | \$4,813 | 28 | \$744 | \$ 87,361 | 134 | \$2,333 |

For securities with unrealized losses, the following information was considered in determining that the impairments were not other-than-temporary:

**Mortgage-backed securities issued by U.S. Government-sponsored enterprises:** As of March 31, 2013, the total unrealized losses on these securities amounted to \$2,149, compared with \$1,064 at December 31, 2012. All of these securities were credit rated AA+ by the major credit rating agencies. Company management believes these securities have minimal credit risk, as these Government-sponsored enterprises play a vital role in the nation's financial markets. Management's analysis indicates that the unrealized losses at March 31, 2013 were attributed to changes in current market yields and pricing spreads for similar securities since the date the underlying securities were purchased, and does not consider these securities to be other-than-temporarily impaired at March 31, 2013.

**Mortgage-backed securities issued by U.S. Government agencies:** As of March 31, 2013, the total unrealized losses on these securities amounted to \$259, compared with \$216 at December 31, 2012. All of these securities were credit rated AA+ by the major credit rating agencies. Management's analysis indicates that these securities bear little or no credit risk because they are backed by the full faith and credit of the United States. The Company attributes the unrealized losses at March 31, 2013 to changes in current market yields and pricing spreads for similar securities since the date the underlying securities were purchased, and does not consider these securities to be other-than-temporarily impaired at March 31, 2013.

**Private label mortgage-backed securities:** As of March 31, 2013, the total unrealized losses on the Bank's private label mortgage-backed securities amounted to \$275, compared with \$521 at December 31, 2012. The Company attributes the unrealized losses at March 31, 2013 to the current illiquid market for non-agency mortgage-backed securities, a still depressed and un-stabilized housing market, elevated levels of home foreclosures, risk-related market pricing discounts for non-agency mortgage-backed securities and credit rating downgrades on certain private label mortgage-backed securities owned by the Company. Based upon the



foregoing considerations and the expectation that the Company will receive all of the future contractual cash flows related to amortized cost on these securities, the Company does not consider there to be any additional other-than-temporary impairment with respect to these securities at March 31, 2013.

**Obligations of states of the U.S. and political subdivisions thereof:** As of March 31, 2013, the total unrealized losses on the Bank's municipal securities amounted to \$909, compared with \$532 at December 31, 2012. The Bank's municipal securities primarily consist of general obligation bonds and to a lesser extent, revenue bonds. General obligation bonds carry less risk, as they are supported by the full faith, credit and taxing authority of the issuing government and in the cases of school districts, are additionally supported by state aid. Revenue bonds are generally backed by municipal revenue streams generated through user fees or lease payments associated with specific municipal projects that have been financed.

Municipal bonds are frequently supported with insurance, which guarantees that in the event the issuer experiences financial problems, the insurer will step in and assume payment of both principal and interest. Historically, insurance support has strengthened an issuer's underlying credit rating to AAA or AA status. Starting in 2008 and continuing through 2013, many of the insurance companies providing municipal bond insurance experienced financial difficulties and, accordingly, were downgraded by at least one of the major credit rating agencies. Consequently, since 2008 a portion of the Bank's municipal bond portfolio was downgraded by at least one of the major credit rating agencies. Notwithstanding the credit rating downgrades, at March 31, 2013, the Bank's municipal bond portfolio did not contain any below investment grade securities as reported by major credit rating agencies. In addition, at March 31, 2013, all municipal bond issuers were current on contractually obligated interest and principal payments.

The Company attributes the unrealized losses at March 31, 2013, to changes in credit ratings on certain securities and resulting changes in prevailing market yields and pricing spreads since the date the underlying securities were purchased. The Company also attributes the unrealized losses to ongoing media attention and market concerns about the prolonged recovery from the national economic recession and the impact it might have on the future financial stability of municipalities throughout the country. Accordingly, the Company does not consider these municipal securities to be other-than-temporarily impaired at March 31, 2013.

At March 31, 2013, the Company had no intent to sell nor believed it is more-likely-than-not that it would be required to sell any of its impaired securities as identified and discussed immediately above, and therefore did not consider these securities to be other-than-temporarily impaired as of that date.

**Securities Gains and Losses:** The following table summarizes realized gains and losses and other-than-temporary impairment losses on securities available for sale for the three months ended March 31, 2013 and 2012.

| <b>Proceeds</b>     | <b>Realized</b> | <b>Realized</b> | <b>Other</b>      |
|---------------------|-----------------|-----------------|-------------------|
| <b>from Sale of</b> | <b>Gains</b>    | <b>Losses</b>   | <b>Than</b>       |
| <b>Securities</b>   |                 |                 | <b>Temporary</b>  |
| <b>Available</b>    |                 |                 | <b>Impairment</b> |
|                     |                 |                 | <b>Net</b>        |

| <b>Three months ended March 31,</b> | <b>for Sale</b> |       |     | <b>Losses</b> |       |
|-------------------------------------|-----------------|-------|-----|---------------|-------|
| <b>2013</b>                         | \$ 5,038        | \$273 | \$8 | \$ ---        | \$265 |
| <b>2012</b>                         | \$11,073        | \$573 | \$6 | \$344         | \$223 |

**Note 6: Loans and Allowance for Loan Losses**

Loans are carried at the principal amounts outstanding adjusted by partial charge-offs and net deferred loan origination costs or fees.

Interest on loans is accrued and credited to income based on the principal amount of loans outstanding. Residential real estate and home equity loans are generally placed on non-accrual status when reaching 90 days past due, or in process of foreclosure, or sooner if judged appropriate by management. Consumer loans are generally placed on non-accrual status when reaching 90 days or more past due, or sooner if judged appropriate by management. Secured consumer loans are written down to realizable value and unsecured consumer loans are charged-off upon reaching 120 days past due. Commercial real estate loans and commercial business loans that are 90 days or more past due are generally placed on non-accrual status, unless secured by sufficient cash or other assets immediately convertible to cash, and the loan is in the process of collection. Commercial real estate and commercial business loans may be placed on non-accrual status prior to the 90 days delinquency date if considered appropriate by management. When a loan has been placed on non-accrual status, previously accrued and uncollected interest is reversed against interest on loans. A loan can be returned to accrual status when principal is reasonably assured and the loan has performed for a period of time, generally six months.

Commercial real estate and commercial business loans are considered impaired when it becomes probable the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and collateral value. In considering loans for evaluation of impairment, management generally excludes smaller balance, homogeneous loans: residential mortgage loans, home equity loans, and all consumer loans, unless such loans were restructured in a troubled debt restructuring. These loans are collectively evaluated for risk of loss.

Loan origination and commitment fees and direct loan origination costs are deferred, and the net amount is amortized as an adjustment of the related loans' yield, using the level yield method over the estimated lives of the related loans.

The Company's lending activities are principally conducted in downeast, midcoast and central Maine. The following table summarizes the composition of the loan portfolio as of March 31, 2013, and December 31, 2012:



**LOAN PORTFOLIO SUMMARY**

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|  | March 31, | December 31, |
|--|-----------|--------------|
|  | 2013      | 2012         |
| Commercial real estate mortgages             | \$315,661 | \$324,493    |
| Commercial and industrial                    | 78,043    | 59,373       |
| Commercial construction and land development | 15,523    | 22,120       |
| Agricultural and other loans to farmers      | 26,399    | 24,922       |
| Total commercial loans                       | 435,626   | 430,908      |
| Residential real estate mortgages            | 296,017   | 297,103      |
| Home equity loans                            | 52,965    | 53,303       |
| Other consumer loans                         | 18,025    | 19,001       |
| Total consumer loans                         | 367,007   | 369,407      |
| Tax exempt loans                             | 15,111    | 15,244       |
| Net deferred loan costs and fees             | (518)     | (555)        |
| Total loans                                  | 817,226   | 815,004      |
| Allowance for loan losses                    | (8,055)   | (8,097)      |
| Total loans net of allowance for loan losses | \$809,171 | \$806,907    |

***Loan Origination/Risk Management:*** The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. The Company's board of directors reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management and the board with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing loans and potential problem loans. The Company seeks to diversify the loan portfolio as a means of managing risk associated with fluctuations in economic conditions.

**Commercial Real Estate Mortgages:** The Bank's commercial real estate mortgage loans are collateralized by liens on real estate, typically have variable interest rates (or five year or less fixed rates) and amortize over a 15 to 20 year period. These loans are underwritten primarily as cash flow loans and secondarily as loans secured by real estate. Payments on loans secured by such properties are largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Accordingly, repayment of these loans may be subject to adverse economic conditions to a greater extent than other types of loans. The Company seeks to minimize these risks in a variety of ways, including giving careful consideration to the property's operating history, future operating projections, current and projected occupancy, location and physical condition in connection with underwriting these loans. The underwriting analysis also includes credit verification, analysis of global cash flows, appraisals and a review of the financial condition of the borrower. Reflecting the Bank's business region, at March 31, 2013, approximately 33.0% of the commercial real estate mortgage portfolio was represented by loans to the lodging industry. The Bank underwrites lodging industry loans as operating businesses, lending primarily to seasonal establishments with stabilized cash flows.

**Commercial and Industrial Loans:** Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably, and prudently expand its business. Commercial and industrial loans are primarily made in the Bank's market areas and are underwritten on the basis of the borrower's

ability to service the debt from income. As a general practice, the Bank takes as collateral a lien on any available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower(s) or principal(s). Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. In general, commercial and industrial loans involve more credit risk than residential mortgage loans and commercial mortgage loans and, therefore, usually yield a higher return. The increased risk in commercial

and industrial loans is principally due to the type of collateral securing these loans. The increased risk also derives from the expectation that commercial and industrial loans generally will be serviced principally from the operations of the business, and, if not successful, these loans are primarily secured by tangible, non-real estate collateral. As a result of these additional complexities, variables and risks, commercial and industrial loans generally require more thorough underwriting and servicing than other types of loans.

**Construction and Land Development Loans:** The Company makes loans to finance the construction of residential and, to a lesser extent, non-residential properties. Construction loans generally are collateralized by first liens on real estate. The Company conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described immediately above are also used in the Company's construction lending activities. Construction loans involve additional risks attributable to the fact that loan funds are advanced against a project under construction and the project is of uncertain value prior to its completion. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan to value ratio. As a result of these uncertainties, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. In many cases the success of the project can also depend upon the financial support/strength of the sponsorship. If the Company is forced to foreclose on a project prior to completion, there is no assurance that the Company will be able to recover the entire unpaid portion of the loan. In addition, the Company may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. While the Company has underwriting procedures designed to identify what it believes to be acceptable levels of risks in construction lending, no assurance can be given that these procedures will prevent losses from the risks described above.

**Residential Real Estate Mortgages:** The Company originates first-lien, adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a single family residential property. These loans are principally collateralized by owner-occupied properties, and are amortized over 10 to 30 years. From time to time the Company will sell longer-term, low rate, residential mortgage loans to the Federal Home Loan Mortgage Corporation ( FHLMC ) with servicing rights retained. This practice allows the Company to better manage interest rate risk and liquidity risk. In an effort to manage risk of loss and strengthen secondary market liquidity opportunities, management typically uses secondary market underwriting, appraisal, and servicing guidelines for all loans, including those held in its portfolio. Loans on one-to-four-family residential real estate are mostly originated in amounts of no more than 80% of appraised value or have private mortgage insurance. Mortgage title insurance and hazard insurance are required. Construction loans have a unique risk, because they are secured by an incomplete dwelling. This risk is reduced through more stringent underwriting standards, including regular inspections throughout the construction period.

**Home Equity Loans:** The Company originates home equity lines of credit and second mortgage loans (loans which are secured by a junior lien position on one-to-four-family residential real estate). These loans carry a higher risk than first mortgage residential loans as they are in a second position relating to collateral. Risk is reduced through underwriting criteria, which include credit verification, appraisals and evaluations, a review of the borrower's financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate.



**Non-performing Loans:** the following table sets forth information regarding non-accruing loans and accruing loans 90 days or more overdue at March 31, 2013, and December 31, 2012.

### TOTAL NON-PERFORMING LOANS

|   | March 31,<br>2013 | December 31,<br>2012 |
|---|-------------------|----------------------|
| Commercial real estate mortgages                      | \$1,633           | \$1,888              |
| Commercial and industrial loans                       | 632               | 818                  |
| Commercial construction and land development          | 2,029             | 2,359                |
| Agricultural and other loans to farmers               | 562               | 664                  |
| Total commercial loans                                | 4,856             | 5,729                |
| Residential real estate mortgages                     | 2,841             | 3,017                |
| Home equity loans                                     | 767               | 814                  |
| Other consumer loans                                  | 81                | 72                   |
| Total consumer loans                                  | 3,689             | 3,903                |
| Total non-accrual loans                               | 8,545             | 9,632                |
| Accruing loans contractually past due 90 days or more | 47                | 235                  |
| Total non-performing loans                            | \$8,592           | \$9,867              |
| Allowance for loan losses to non-performing loans     | 93.8%             | 82.1%                |
| Non-performing loans to total loans                   | 1.05%             | 1.21%                |
| Allowance to total loans                              | 0.99%             | 0.99%                |

**Troubled Debt Restructures:** A Troubled Debt Restructure ( TDR ) results from a modification to a loan to a borrower who is experiencing financial difficulty in which the Bank grants a concession to the debtor that it would not otherwise consider but for the debtor's financial difficulties. Financial difficulty arises when a debtor is bankrupt or contractually past due, or is likely to become so, based upon its ability to pay. A concession represents an accommodation not generally available to other customers, which may include a below-market interest rate, deferment of principal payments, extension of maturity dates, etc. Such accommodations extended to customers who are not experiencing financial difficulty do not result in TDR classification.

Summary information pertaining to the TDRs that occurred during the three months ended March 31, 2013, and March 31, 2012, follows:

**For the Three Months Ended**

**March 31,**

**For the Three Months Ended**

**March 31,**

|                       | 2013               |   |  | 2012               |   |  |
|-----------------------|--------------------|---|--|--------------------|---|--|
|                       |                    | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |                    | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|                       | Number of<br>Loans |   |  | Number of<br>Loans |   |  |
| Residential real      |                    |   |  |                    |   |  |
| estate mortgages      | 0                  | \$---   | \$---  | 1                  | \$58  | \$58   |
| Home equity           |                    |   |  |                    |   |  |
| loans                 | 1                  | 16  | 22   | 0                  | ---   | ---  |
| Other consumer        |                    |   |  |                    |   |  |
| loans                 | 1                  | 14  | 14   | 0                  | ---   | ---  |
| <b>Total consumer</b> |                    |   |  |                    |   |  |
| <b>loans</b>          | 2                  | 30  | \$36   | 1                  | 58  | 58   |
| <b>Total</b>          | 2                  | \$30  | \$36   | 1                  | \$58  | \$58   |

The following table shows the Company's post-modification balance of TDRs listed by type of modification for the three months ended March 31, 2013 and 2012:

|  | 2013        | 2012        |
|--|-------------|-------------|
| Extended maturity and adjusted interest rate | \$36        | \$---       |
| Temporary payment amount adjustment          | ---         | 58          |
| <b>Total</b>                                 | <b>\$36</b> | <b>\$58</b> |

As of March 31, 2013, the Bank had six real estate secured loans, three commercial and industrial loan, and one consumer loan, to five relationships totaling \$1,148 that were classified as TDRs. At March 31, 2013, five of these TDRs totaling \$1,016 were past due and classified as non-accrual.

As of December 31, 2012, the Bank had four real estate secured and three commercial and industrial loans to four relationships totaling \$934 that were classified as TDRs. At December 31, 2012, three TDRs totaling \$114 were past due or classified as non-performing.

**Past Due Loans:** Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. The following tables set forth information regarding past due loans at March 31, 2013, and December 31, 2012. Amounts shown exclude deferred loan origination fees and costs.

| March 31, 2013                    | 30-59    |          |         | 90       | Total     | Total     | Total   | Total    |
|-----------------------------------|----------|----------|---------|----------|-----------|-----------|---------|----------|
|                                   | Days     | 60-89    | Days    |          |           |           |         |          |
|                                   | Past Due | Past Due | Greater | Past Due | Current   | Loans     | Loans   | Accruing |
| Commercial real estate mortgages  | \$ 1,639 | \$ 219   | \$1,144 | \$ 3,002 | \$312,659 | \$315,661 | \$1,633 | \$ ---   |
| Commercial and industrial         | 596      | 215      | 589     | 1,400    | 76,643    | 78,043    | 632     | ---      |
| Commercial construction           |          |          |         |          |           |           |         |          |
| and land development              | 77       | ---      | 2,029   | 2,106    | 13,417    | 15,523    | 2,029   | ---      |
| Agricultural and other            |          |          |         |          |           |           |         |          |
| loans to farmers                  | 130      | 144      | 490     | 764      | 25,635    | 26,399    | 562     | ---      |
| Residential real estate mortgages | 3,951    | 296      | 1,824   | 6,071    | 289,946   | 296,017   | 2,841   | 28       |
| Home equity                       | 63       | 19       | 257     | 339      | 52,626    | 52,965    | 767     | ---      |

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|                      |          |        |         |          |           |           |         |       |
|----------------------|----------|--------|---------|----------|-----------|-----------|---------|-------|
| Other consumer loans | 129      | 36     | 89      | 254      | 17,771    | 18,025    | 81      | 19    |
| Tax exempt           | ---      | ---    | ---     | ---      | 15,111    | 15,111    | ---     | ---   |
| Total                | \$ 6,585 | \$ 929 | \$6,422 | \$13,936 | \$803,808 | \$817,744 | \$8,545 | \$ 47 |

| December 31, 2012                 | 30-59    |               |                          | Total    | Current   | Total<br>Loans | Non-Accrual | >90 Days<br>Past Due<br>and<br>Accruing |
|-----------------------------------|----------|---------------|--------------------------|----------|-----------|----------------|-------------|---|
|                                   | Days     | 60-89<br>Days | 90<br>Days or<br>Greater |          |           |                |             |   |
| Commercial real estate mortgages  | \$ 228   | \$ 238        | \$1,041                  | \$ 1,507 | \$322,986 | \$324,493      | \$1,888     | \$---                                   |
| Commercial and industrial         | 22       | 61            | 990                      | 1,073    | 58,300    | 59,373         | 818         | 216                                     |
| Commercial construction           |          |               |                          |          |           |                |             |   |
| and land development              | ---      | ---           | 2,359                    | 2,359    | 19,761    | 22,120         | 2,359       | ---                                     |
| Agricultural and other            |          |               |                          |          |           |                |             |   |
| loans to farmers                  | 203      | 12            | 490                      | 705      | 24,217    | 24,922         | 664         | ---                                     |
| Residential real estate mortgages | 2,452    | 769           | 1,951                    | 5,172    | 291,931   | 297,103        | 3,017       | ---                                     |
| Home equity                       | 219      | ---           | 274                      | 493      | 52,810    | 53,303         | 814         | ---                                     |
| Other consumer loans              | 75       | 97            | 77                       | 249      | 18,752    | 19,001         | 72          | 19                                      |
|                                   | ---      | ---           | ---                      | ---      |           |                |             |   |
| Tax exempt                        |          | ---           | ---                      |          | 15,244    | 15,244         | ---         | ---                                     |
| Total                             | \$ 3,199 | \$1,177       | \$7,182                  | \$11,558 | \$804,001 | \$815,559      | \$9,632     | \$235                                   |

**Impaired Loans:** Impaired loans are all commercial loans for which the Company believes it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement, as well as all loans modified into a TDR, if any. Allowances for losses on impaired loans are determined by the lower of the present value of the expected cash flows related to the loan, using the original contractual interest rate, and its recorded value, or in the case of collateral dependant loans, the lower of the fair value of the collateral, less costs to dispose, and the recorded amount of the loans. When foreclosure is probable, impairment is measured based on the fair value of the collateral less cost to sell.

Details of impaired loans as of March 31, 2013 and December 31, 2012 follows:

|                                   | March 31, 2013 |           |           | December 31, 2012 |           |           |
|-----------------------------------|----------------|-----------|-----------|-------------------|-----------|-----------|
|                                   | Unpaid         |           |           | Unpaid            |           |           |
|                                   | Recorded       | Principal | Related   | Recorded          | Principal | Related   |
|                                   | Investment     | Balance   | Allowance | Investment        | Balance   | Allowance |
| <b>With no related allowance:</b> |                |           |           |                   |           |           |
| Commercial real estate mortgages  | \$2,163        | \$2,525   | \$---     | \$2,662           | \$3,072   | \$---     |
| Commercial and industrial         | 654            | 714       | ---       | 841               | 966       | ---       |
| Commercial construction           |                |           |           |                   |           |           |
| and land development              | ---            | ---       | ---       | ---               | ---       | ---       |
| Agricultural and other            |                |           |           |                   |           |           |
| loans to farmers                  | 562            | 637       | ---       | 664               | 748       | ---       |
| Residential real estate loans     | 266            | 296       | ---       | 77                | 77        | ---       |
| Home equity loans                 | 22             | 22        | ---       | ---               | ---       | ---       |
| Other consumer                    | 14             | 14        | ---       | ---               | ---       | ---       |
| Subtotal                          | \$3,681        | \$4,208   | \$---     | \$4,244           | \$4,863   | \$---     |
| <b>With an allowance:</b>         |                |           |           |                   |           |           |
| Commercial real estate mortgages  | \$ 239         | \$ 239    | \$ 75     | \$ ---            | \$ ---    | \$ ---    |
| Commercial and industrial         | ---            | ---       | ---       | ---               | ---       | ---       |
| Commercial construction           |                |           |           |                   |           |           |
| and land development              | 2,029          | 3,954     | 45        | 2,359             | 4,329     | 120       |
| Agricultural and other            |                |           |           |                   |           |           |
| loans to farmers                  | ---            | ---       | ---       | ---               | ---       | ---       |
| Residential real estate loans     | ---            | ---       | ---       | ---               | ---       | ---       |
| Home equity loans                 | ---            | ---       | ---       | ---               | ---       | ---       |
| Other consumer                    | ---            | ---       | ---       | ---               | ---       | ---       |
| Subtotal                          | \$2,268        | \$4,193   | \$120     | \$2,359           | \$4,329   | \$120     |
| Total                             | \$5,949        | \$8,401   | \$120     | \$6,603           | \$9,192   | \$120     |

Details of impaired loans for the three months ended March 31, 2013 and 2012 follows:

March 31, 2013

March 31, 2012

|  | <b>Average</b>             |                 | <b>Average</b>             |                 |
|--|----------------------------|-----------------|----------------------------|-----------------|
|  | <b>Recorded</b>            | <b>Interest</b> | <b>Recorded</b>            | <b>Interest</b> |
|  | <b>Investment Recorded</b> |                 | <b>Investment Recorded</b> |                 |
| <b>With no related allowance:</b>            |                            |                 |                            |                 |
| Commercial real estate mortgages             | \$2,245                    | \$17            | \$3,190                    | \$55            |
| Commercial and industrial                    | 917                        | 1               | 913                        | ---             |
| Commercial construction and land development | 205                        | ---             | 3,024                      | ---             |
| Agricultural and other loans to farmers      | 582                        | ---             | 592                        | ---             |
| Residential real estate mortgages            | 268                        | 2               | 140                        | ---             |
| Home equity loans                            | 18                         | 1               | ---                        | ---             |
| Other consumer                               | 2                          | ---             | ---                        | ---             |
| Subtotal                                     | \$4,237                    | \$ 21           | \$7,859                    | \$55            |
| <b>With an allowance:</b>                    |                            |                 |                            |                 |
| Commercial real estate mortgages             | \$ 239                     | \$---           | \$ 367                     | \$---           |
| Commercial and industrial                    | ---                        | ---             | 100                        | ---             |
| Commercial construction and land development | 2,029                      | ---             | 761                        | ---             |
| Agricultural and other loans to farmers      | ---                        | ---             | ---                        | ---             |
| Residential real estate mortgages            | ---                        | ---             | ---                        | ---             |
| Home equity loans                            | ---                        | ---             | ---                        | ---             |
| Other consumer                               | ---                        | ---             | ---                        | ---             |
| Subtotal                                     | \$2,268                    | \$---           | \$1,228                    | \$---           |
| Total  | \$6,505                    | \$21            | \$9,087                    | \$55            |

***Credit Quality Indicators/Classified Loans:*** In monitoring the credit quality of the portfolio, management applies a credit quality indicator to all categories of commercial loans. These credit quality indicators range from one through nine, with a higher number correlating to increasing risk of loss. These ratings are used as inputs to the calculation of the allowance for loan losses. Loans rated one through five are consistent with the regulators' Pass ratings, and are generally allocated a lesser percentage allocation in the allowance for loan losses than loans rated from six through nine.

Consistent with regulatory guidelines, the Bank provides for the classification of loans which are considered to be of lesser quality as substandard, doubtful, or loss. The Bank considers a loan substandard if it is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well defined weakness that jeopardizes liquidation of the debt. Substandard loans include those loans where there is the distinct possibility of some loss of principal, if the deficiencies are not corrected.

Loans that the Bank classifies as doubtful have all of the weaknesses inherent in those loans that are classified as substandard but also have the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is high but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans. The entire amount of the loan might not be classified as doubtful when collection of a specific portion appears highly probable. Loans are generally not classified doubtful for an extended period of time (i.e., over a year).

Loans that the Bank classifies as loss are those considered uncollectible and of such little value that their continuance as an asset is not warranted and the uncollectible amounts are charged off. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. Losses are taken in the period in which they surface as uncollectible.

Loans that do not expose the Bank to risk sufficient to warrant classification in one of the aforementioned categories, but which possess some weaknesses, are designated special mention. A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. This might include loans which the lending officer may be unable to supervise properly because of: lack of expertise, inadequate loan agreement, the poor condition of or lack of control over collateral, failure to obtain proper documentation or any other deviations from prudent lending practices. Economic or market conditions which may, in the future, affect the obligor may warrant special mention of the asset. Loans for which an adverse trend in the borrower's operations or an imbalanced position in the balance sheet which has not reached a point where the liquidation is jeopardized may be included in this classification. Special mention assets are not adversely classified and do not expose an institution to sufficient risks to warrant classification.

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The following tables summarize the commercial loan portfolio as of March 31, 2013, and December 31, 2012, by credit quality indicator. Credit quality indicators are reassessed for each applicable commercial loan at least annually, or upon receipt and analysis of the borrower's financial statements, when applicable. Consumer loans, which principally consist of residential mortgage loans, are not rated, but are evaluated for credit quality after origination based on delinquency status (see past due loan aging table above).

| <b>March 31, 2013</b>   | <b>Commercial<br/>real estate<br/>mortgages</b> | <b>Commercial<br/>and industrial</b> | <b>Commercial<br/>construction<br/>and land<br/>development</b> | <b>Agricultural<br/>and other<br/>loans to<br/>farmers</b> | <b>Total</b> |
|-------------------------|---|--------------------------------------|---|--|--------------|
| Pass                    | \$284,940                                       | \$66,188                             | \$11,318  | \$25,312   | \$387,758    |
| Other Assets Especially |   |                                      |   |  |              |
| Mentioned               | 21,078  | 8,572                                | 2,176   | 241  | 32,067       |
| Substandard             | 9,643   | 3,283                                | 2,029   | 846  | 15,801       |
| Doubtful                | ---   | ---                                  | ---   | ---  | ---          |
| Loss                    | ---   | ---                                  | ---   | ---  | ---          |
| Total                   | \$315,661                                       | \$78,043                             | \$15,523  | \$26,399   | \$435,626    |

| <b>December 31, 2012</b> | <b>Commercial<br/>real estate<br/>mortgages</b> | <b>Commercial<br/>and industrial</b> | <b>Commercial<br/>construction<br/>and land<br/>development</b> | <b>Agricultural<br/>and other<br/>loans to<br/>farmers</b> | <b>Total</b> |
|--------------------------|---|--------------------------------------|---|--|--------------|
| Pass                     | \$293,505                                       | \$46,872                             | \$17,469  | \$23,806   | \$381,652    |
| Other Assets Especially  |   |                                      |   |  |              |
| Mentioned                | 21,522  | 9,112                                | 2,292   | 242  | 33,168       |
| Substandard              | 9,466   | 3,389                                | 2,359   | 874  | 16,088       |
| Doubtful                 | ---   | ---                                  | ---   | ---  | ---          |
| Loss                     | ---   | ---                                  | ---   | ---  | ---          |
| Total                    | \$324,493                                       | \$59,373                             | \$22,120  | \$24,922   | \$430,908    |

**Allowance for Loan Losses:** The allowance for loan losses (the allowance) is a reserve established through a provision for loan losses (the provision) charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to provide for estimated loan losses and risks inherent in the loan portfolio. The Company's allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, Receivables and allowance allocations calculated in accordance with ASC Topic 450, Contingencies. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Company's process for determining the appropriate level of the allowance is designed to account for credit deterioration as it occurs. The provision reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including, among other things, the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Company's allowance for loan losses consists of three principal elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship level for all commercial loans. When a loan has a classification of seven or higher, the Company analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other observable considerations.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Company calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool, net of any loans for which reserves are already established. The Company's pools of similar loans include similarly risk-graded groups of, commercial real estate loans, commercial and industrial loans, consumer real estate loans and consumer and other loans.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the Bank's lending management and staff; (ii) the effectiveness of the Bank's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the impact of competition on loan structuring and pricing; (vii) the effectiveness of the internal loan review function; (viii) the impact of environmental risks on portfolio risks; and (ix) the impact of rising interest rates on portfolio risk. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. The results are then used to determine an appropriate general valuation allowance.

Loans identified as losses by management, internal loan review and/or bank examiners, are charged-off. Furthermore, consumer loan accounts are charged-off based on regulatory requirements.

The following tables detail activity in the allowance for loan losses by portfolio segment for the three months ended March 31, 2013, and 2012. The tables also provide details regarding the Company's recorded investment in loans

related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Company's impairment methodology. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

| <b>Three<br/>Months<br/>Ended<br/>March 31,<br/>2013</b> | <b>Commercial<br/>Real Estate</b> | <b>Commercial<br/>and<br/>Industrial</b> | <b>Commercial Construction<br/>and land<br/>development</b> | <b>Agricultural</b> | <b>Residential<br/>Real<br/>Estate</b> | <b>Consumer</b> | <b>Home<br/>Equity</b> | <b>Tax<br/>Exempt</b> | <b>Total</b> |
|--|-----------------------------------|--|---|---------------------|--|-----------------|------------------------|-----------------------|--------------|
| Beginning  |                                   |  |   |                     |  |                 |                        |                       |              |
| Balance  | \$ 4,320                          | \$1,026                                  | \$ 515  | \$ 303              | \$ 1,330                               | \$ 207          | \$ 255                 | \$ 141                | \$ 8,097     |
| Charged Off  | ---                               | (164)                                    | ---   | ---                 | (228)                                  | (28)            | (9)                    | ---                   | (429)        |
| Recoveries   | ---                               | 10                                       | ---   | 1                   | ---                                    | 5               | 18                     | ---                   | 34           |
| Provision  | 93                                | 139                                      | (175)   | 33                  | 252                                    | 13              | ---                    | (2)                   | 353          |
| Ending   |                                   |  |   |                     |  |                 |                        |                       |              |
| Balance  | \$ 4,413                          | \$ 1,011                                 | \$ 340  | \$ 337              | \$ 1,354                               | \$ 197          | \$ 264                 | \$ 139                | \$ 8,055     |

of which:

Amount for  
loans

individually  
evaluated  
for

|            |       |        |       |        |        |        |        |        |        |
|------------|-------|--------|-------|--------|--------|--------|--------|--------|--------|
| impairment | \$ 75 | \$ --- | \$ 45 | \$ --- | \$ --- | \$ --- | \$ --- | \$ --- | \$ 120 |
|------------|-------|--------|-------|--------|--------|--------|--------|--------|--------|

Amount for  
loans

collectively  
evaluated  
for

|            |          |          |        |        |          |        |        |        |          |
|------------|----------|----------|--------|--------|----------|--------|--------|--------|----------|
| impairment | \$ 4,338 | \$ 1,011 | \$ 295 | \$ 337 | \$ 1,354 | \$ 197 | \$ 264 | \$ 139 | \$ 7,935 |
|------------|----------|----------|--------|--------|----------|--------|--------|--------|----------|

Loans  
individually

evaluated  
for

|            |          |        |          |        |        |        |        |        |          |
|------------|----------|--------|----------|--------|--------|--------|--------|--------|----------|
| impairment | \$ 1,633 | \$ 632 | \$ 2,029 | \$ 562 | \$ --- | \$ --- | \$ --- | \$ --- | \$ 4,856 |
|------------|----------|--------|----------|--------|--------|--------|--------|--------|----------|

Loans  
collectively

evaluated  
for

|            |           |          |          |          |           |          |          |          |           |
|------------|-----------|----------|----------|----------|-----------|----------|----------|----------|-----------|
| impairment | \$314,028 | \$77,411 | \$13,494 | \$25,837 | \$296,017 | \$18,025 | \$52,965 | \$15,111 | \$812,888 |
|------------|-----------|----------|----------|----------|-----------|----------|----------|----------|-----------|

**Agricultural**

**Consumer**

**Total**

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| <b>Three Months Ended March 31, 2012</b> | <b>Commercial Real Estate</b> | <b>Commercial and Industrial</b> | <b>Commercial Construction and land development</b> |        | <b>Residential Real Estate</b> |        | <b>Home Equity</b> |       | <b>Tax Exempt</b> |  |
|--|-------------------------------|----------------------------------|---|--------|--------------------------------|--------|--------------------|-------|-------------------|--|
| Beginning Balance                        | \$ 3,900                      | \$ 1,321                         | \$ 594  | \$ 332 | \$ 1,436                       | \$ 286 | \$ 266             | \$ 86 | \$ 8,221          |  |
| Charged Off                              | (25)                          | (17)                             | ---   | (10)   | (182)                          | (119)  | ---                | ---   | (353)             |  |
| Recoveries                               | 1                             | 6                                | ---   | 25     | ---                            | 6      | ---                | ---   | 38                |  |
| Provision                                | 392                           | 11                               | (109)   | (11)   | 32                             | 145    | (15)               | (30)  | 415               |  |
| Ending Balance                           | \$ 4,268                      | \$ 1,321                         | \$ 485  | \$ 336 | \$ 1,286                       | \$ 318 | \$ 251             | \$ 56 | \$ 8,321          |  |

of which:

Amount for loans

individually evaluated

|                |        |        |        |        |        |        |        |        |        |
|----------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| for impairment | \$ 229 | \$ 100 | \$ 100 | \$ --- | \$ --- | \$ --- | \$ --- | \$ --- | \$ 429 |
|----------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|

Amount for loans

collectively evaluated

|                |          |          |        |        |          |        |        |       |          |
|----------------|----------|----------|--------|--------|----------|--------|--------|-------|----------|
| for impairment | \$ 4,039 | \$ 1,221 | \$ 385 | \$ 336 | \$ 1,286 | \$ 318 | \$ 251 | \$ 56 | \$ 7,892 |
|----------------|----------|----------|--------|--------|----------|--------|--------|-------|----------|

Loans individually

evaluated for

|            |          |        |          |        |        |        |        |        |          |
|------------|----------|--------|----------|--------|--------|--------|--------|--------|----------|
| impairment | \$ 2,705 | \$ 713 | \$ 3,844 | \$ 632 | \$ --- | \$ --- | \$ --- | \$ --- | \$ 7,894 |
|------------|----------|--------|----------|--------|--------|--------|--------|--------|----------|

Loans collectively

evaluated for

|            |           |          |          |          |           |          |          |          |           |
|------------|-----------|----------|----------|----------|-----------|----------|----------|----------|-----------|
| impairment | \$290,238 | \$66,007 | \$21,052 | \$27,215 | \$267,059 | \$21,473 | \$51,199 | \$11,181 | \$755,424 |
|------------|-----------|----------|----------|----------|-----------|----------|----------|----------|-----------|



***Loan concentrations:*** Because of the Company's proximity to Acadia National Park, a large part of the economic activity in the Bank's area is generated from the hospitality business associated with tourism. At March 31, 2013, and December 31, 2012, loans to the lodging industry amounted to approximately \$108,729 and \$105,699, respectively.

**Note 7: Reclassifications Out of Accumulated Other Comprehensive Income**

The following table summarizes the reclassifications out of Accumulated Other Comprehensive Income for the three months ended March 31, 2013.

| <b>Details about Accumulated<br/>Other Comprehensive Income</b>  | <b>Amount Reclassified<br/>from Accumulated<br/>Other Comprehensive<br/>Income</b> | <b>Affected Line Item<br/>in the Statement Where<br/>Net Income is Presented</b> |
|--|--|--|
| Unrealized gains and losses on available-for-sale securities   |  |  |
|  | \$ 265   | Net gain on sales of investments   |
|  | (90)   | Provision for income taxes   |
|  | \$ 175   | Net income   |
| Amortization of post retirement benefit plan<br>Net amortization prior service costs and actuarial gain/loss |  |  |
| for supplemental executive retirement plan   | \$ (82)  | Salaries and benefits  |
| Amortization of actuarial gain/loss for supplemental<br>executive retirement plan                            | 15   | Salaries and benefits  |
|  | (67)   |  |
| Tax (expense) or benefit   | (23)   | Provision for income taxes   |
| Net of tax   | \$ (44)  | Net income   |
| Total reclassification for the period  | \$ 131   | Net income, net of tax   |

**Note 8: Retirement Benefit Plans**

The Company has non-qualified supplemental executive retirement agreements with certain retired officers. The agreements provide supplemental retirement benefits payable in installments over a period of years upon retirement or death. The Company recognized the net present value of payments associated with the agreements over the service periods of the participating officers. Interest costs continue to be recognized on the benefit obligations.

The Company also has supplemental executive retirement agreements with certain current executive officers. These agreements provide a stream of future payments in accordance with individually defined vesting schedules upon retirement, termination, or upon a change of control.

The following table summarizes the net periodic benefit costs for the three months ended March 31, 2013, and 2012:

| <b>Three Months Ended March 31,</b>                                  | <b>Supplemental Executive Retirement Plans</b> |             |
|--|--|-------------|
|  | <b>2013</b>                                    | <b>2012</b> |
| Service cost   | \$91   | \$37        |
| Interest cost  | 30   | 24          |
| Net amortization of prior service cost and actuarial (gain)/loss     | (82)   | ---         |
| Actuarial loss on supplemental executive retirement plan, net of tax | 15   | ---         |
| Net periodic benefit cost  | \$54   | \$61        |

The Company is expected to recognize \$224 of expense for the foregoing plans for the year ended December 31, 2013. The Company is expected to contribute \$206 to the foregoing plans in 2013. As of March 31, 2013, the Company had contributed \$49.

**Note 9: Commitments and Contingent Liabilities**

The Company's wholly owned subsidiary, Bar Harbor Bank & Trust (the Bank), is a party to financial instruments in the normal course of business to meet financing needs of its customers. These financial instruments include commitments to extend credit, unused lines of credit, and standby letters of credit.

Commitments to originate loans, including unused lines of credit, are agreements to lend to a customer provided there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank uses the same credit policy to make such commitments as it uses for on-balance-sheet items, such as loans. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower.

The Bank guarantees the obligations or performance of customers by issuing standby letters of credit to third parties. These standby letters of credit are primarily issued in support of third party debt or obligations. The risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination, portfolio maintenance and management procedures in effect to monitor other credit and off-balance sheet instruments. Exposure to credit loss in the event of non-performance by the counter-party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. Typically, these standby letters of credit have terms of five years or less and expire unused; therefore, the total amounts do not necessarily represent future cash requirements.

The following table summarizes the contractual amounts of commitments and contingent liabilities as of March 31, 2013, and December 31, 2012:

|  | <b>March 31,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|--|---------------------------|------------------------------|
| Commitments to originate loans             | \$ 30,376                 | \$ 20,843                    |
| Unused lines of credit                     | \$102,106                 | \$106,773                    |
| Commitment to purchase loans               | \$ 20,000                 | \$ ---                       |
| Un-advanced portions of construction loans | \$ 24,497                 | \$ 22,047                    |
| Standby letters of credit                  | \$ 245                    | \$ 307                       |

As of March 31, 2013, and December 31, 2012, the fair value of the standby letters of credit was not significant to the Company's consolidated financial statements.

#### **Note 10: Goodwill and Other Intangible Assets**

**Goodwill:** Goodwill totaled \$4,935 at March 31, 2013, and December 31, 2012. In the third quarter of 2012 the Company recorded \$1,777 of goodwill in connection with the Bank's acquisition of substantially all of the assets and the assumption of certain liabilities including all deposits of the Border Trust Company.

**Core Deposit Intangible Asset:** The Company has a finite-lived intangible asset capitalized on its consolidated balance sheet in the form of a core deposit intangible asset related to the Border Trust Company acquisition. The core deposit intangible is being amortized over an estimated useful life of eight and one-half years and is included in other assets on the Company's consolidated balance sheet. At March 31, 2013, and December 31, 2012, the balance of the core deposit intangible asset amounted to \$724 and \$747, respectively. Amortization of the core deposit intangible asset is expected to be \$92 and \$92 for 2013 and 2014, respectively.

#### **Note 11: Fair Value Measurements**

The Company measures fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact, and (iv) willing to transact.

The Company's fair value measurements employ valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the servicing capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The Company uses a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets (Level 1 measurements) for identical assets or liabilities and the lowest priority to unobservable inputs (Level 3 measurements). The fair value hierarchy is as follows:

*Level 1* Valuation is based on unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

*Level 2* Valuation is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and model-based techniques for which all significant assumptions are observable in the market.

*Level 3* Valuation is principally generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates that market participants would use in pricing the asset or liability. Valuation techniques include use of discounted cash flow models and similar techniques.

The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

The most significant instruments that the Company values are securities, all of which fall into Level 2 in the fair value hierarchy. The securities in the available for sale portfolio are priced by independent providers. In obtaining such valuation information from third parties, the Company has evaluated their valuation methodologies used to develop the fair values in order to determine whether valuations are appropriately placed within the fair value hierarchy and whether the valuations are representative of an exit price in the Company's principal markets. The Company's principal markets for its securities portfolios are the secondary institutional markets, with an exit price that is predominantly reflective of bid level pricing in those markets. Additionally, the Company periodically tests the reasonableness of the prices provided by these third parties by obtaining fair values from other independent providers and by obtaining desk bids from a variety of institutional brokers.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

***Securities Available for Sale:*** All securities and major categories of securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from independent pricing providers. The fair value measurements used by the pricing providers consider observable data that may include dealer quotes, market maker quotes and live trading systems. If quoted prices are not readily available, fair values are determined using matrix pricing models, or other model-based valuation techniques requiring observable inputs other than quoted prices such as market pricing spreads, credit information, callable features, cash flows, the U.S. Treasury yield curve, trade execution data, market consensus prepayment speeds, default rates, and the securities terms and conditions, among other things.

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The foregoing valuation methodologies may produce fair value calculations that may not be fully indicative of net realizable value or reflective of future fair values. While Company management believes these valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The following tables summarize financial assets and financial liabilities measured at fair value on a recurring basis as of March 31, 2013, and December 31, 2012, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| <b>March 31, 2013</b>                                    | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Total Fair<br/>Value</b> |
|--|---------------------------|---------------------------|---------------------------|-----------------------------|
| Securities available for sale:                           |                           |                           |                           |                             |
| Mortgage-backed securities:                              |                           |                           |                           |                             |
| US Government-sponsored enterprises                      | \$ ---                    | \$248,934                 | \$ ---                    | \$248,934                   |
| US Government agencies                                   | \$ ---                    | \$ 89,267                 | \$ ---                    | \$ 89,267                   |
| Private label  | \$ ---                    | \$ 7,874                  | \$ ---                    | \$ 7,874                    |
| Obligations of states and political subdivisions thereof | \$ ---                    | \$ 77,839                 | \$ ---                    | \$ 77,839                   |

| <b>December 31, 2012</b>                                 | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Total Fair<br/>Value</b> |
|--|---------------------------|---------------------------|---------------------------|-----------------------------|
| Securities available for sale:                           |                           |                           |                           |                             |
| Mortgage-backed securities:                              |                           |                           |                           |                             |
| US Government-sponsored enterprises                      | \$ ---                    | \$245,823                 | \$ ---                    | \$245,823                   |
| US Government agencies                                   | \$ ---                    | \$ 84,261                 | \$ ---                    | \$ 84,261                   |
| Private label  | \$ ---                    | \$ 8,113                  | \$ ---                    | \$ 8,113                    |
| Obligations of states and political subdivisions thereof | \$ ---                    | \$ 79,843                 | \$ ---                    | \$ 79,843                   |

The following tables summarize financial assets and financial liabilities measured at fair value during the periods indicated, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value.

|                                     | Level 1 | Level 2 | Level 3 | Fair Value    |        |
|-------------------------------------|---------|---------|---------|---------------|--------|
| For the Three Months Ended 3/31/13  | Inputs  | Inputs  | Inputs  | as of 3/31/13 | Loss   |
| Other real estate owned             | \$ ---  | \$ ---  | \$2,805 | \$2,805       | \$ 5   |
| Collateral dependent impaired loans | \$ ---  | \$ ---  | \$ 239  | \$ 239        | \$ --- |

|                                     | Level 1 | Level 2 | Level 3 | Fair Value    |        |
|-------------------------------------|---------|---------|---------|---------------|--------|
| For the Three Months Ended 3/31/12  | Inputs  | Inputs  | Inputs  | as of 3/31/12 | Loss   |
| Other real estate owned             | \$ ---  | \$ ---  | \$3,042 | \$3,042       | \$ --- |
| Collateral dependent Impaired loans | \$ ---  | \$ ---  | \$ 156  | \$ 156        | \$ --- |

The Company had total collateral dependent impaired loans with carrying values of approximately \$2,826 and \$3,149 which had specific reserves included in the allowance of \$120 at March 31, 2013 and December 31, 2012. The Company measures the value of collateral dependent impaired loans using Level 3 inputs. Specifically, the Company uses the appraised value of the collateral, which is then discounted for estimated costs to dispose and other considerations. These discounts generally range from 10% to 30% of appraised value.

In estimating the fair value of OREO, the Company generally uses market appraisals less estimated costs to dispose of the property, which generally range from 10% to 30% of appraised value. Management may also make adjustments to reflect estimated fair value declines, or may apply other discounts to appraised values for unobservable factors resulting from its knowledge of the property or consideration of broker quotes. The appraisers use a market, income, and/or a cost approach in determining the value of the collateral. Therefore they have been categorized as a Level 3 measurement.

There were no transfers between levels during the periods presented.

#### Note 12: Fair Value of Financial Instruments

The Company discloses fair value information about financial instruments for which it is practicable to estimate fair value. Fair value estimates are made as of a specific point in time based on the characteristics of the financial instruments and relevant market information. Where available, quoted market prices are used. In other cases, fair values are based on estimates using present value or other valuation techniques. These techniques involve uncertainties and are significantly affected by the assumptions used and judgments made regarding risk characteristics of various financial instruments, discount rates, estimates of future cash flows, future expected loss experience and other factors. Changes in assumptions could significantly affect these estimates. Derived fair value estimates cannot be substantiated by comparison to independent markets and, in certain cases, could not be realized in an immediate

sale of the instrument.

Fair value estimates are based on existing financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Accordingly, the aggregate fair value amounts presented do not purport to represent the underlying market value of the Company.

The following describes the methods and significant assumptions used by the Company in estimating the fair values of significant financial instruments:

**Cash and Cash Equivalents:** For cash and cash equivalents, including cash and due from banks and other short-term investments with maturities of 90 days or less, the carrying amounts reported on the consolidated balance sheet approximate fair values.

**Federal Home Loan Bank stock:** For Federal Home Loan Bank stock, the carrying amounts report on the consolidated balance sheet approximate fair values.

**Loans:** For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of other loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

**Deposits:** The fair value of deposits with no stated maturity is equal to the carrying amount. The fair value of time deposits is based on the discounted value of contractual cash flows, applying interest rates currently being offered on wholesale funding products of similar maturities. The fair value estimates for deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of alternative forms of funding ( deposit base intangibles ).

**Borrowings:** For borrowings that mature or re-price in 90 days or less, carrying value approximates fair value. The fair value of the Company's remaining borrowings is estimated by using discounted cash flows based on current rates available for similar types of borrowing arrangements taking into account any optionality.

**Accrued Interest Receivable and Payable:** The carrying amounts of accrued interest receivable and payable approximate their fair values.

**Off-Balance Sheet Financial Instruments:** The Company's off-balance sheet instruments consist of loan commitments and standby letters of credit. Fair values for standby letters of credit and loan commitments were insignificant.

A summary of the carrying values and estimated fair values of the Company's significant financial instruments at March 31, 2013, and December 31, 2012, follows:

|                                    |                 |                |                |                | <b>Total</b>      |
|------------------------------------|-----------------|----------------|----------------|----------------|-------------------|
|                                    | <b>Carrying</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Fair Value</b> |
| <b>March 31, 2013</b>              | <b>Value</b>    | <b>Inputs</b>  | <b>Inputs</b>  | <b>Inputs</b>  |                   |
| Financial Assets:                  |                 |                |                |                |                   |
| Cash and cash equivalents          | \$ 10,305       | \$10,305       | \$ ---         | \$ ---         | \$ 10,305         |
| Federal Home Loan Bank stock       | \$ 18,108       | \$ ---         | \$ 18,108      | \$ ---         | \$ 18,108         |
| Loans, net                         | \$809,171       | \$ ---         | \$ ---         | \$823,425      | \$823,425         |
| Interest receivable                | \$ 5,318        | \$ 5,318       | \$ ---         | \$ ---         | \$ 5,318          |
| Financial liabilities:             |                 |                |                |                |                   |
| Deposits (with no stated maturity) | \$401,183       | \$ ---         | \$401,183      | \$ ---         | \$401,183         |
| Time deposits                      | \$399,917       | \$ ---         | \$406,066      | \$ ---         | \$406,066         |
| Borrowings                         | \$371,663       | \$ ---         | \$376,567      | \$ ---         | \$376,567         |
| Interest payable                   | \$ 689          | \$ 689         | \$ ---         | \$ ---         | \$ 689            |

|                                    |                 |                |                |                | <b>Total</b>      |
|------------------------------------|-----------------|----------------|----------------|----------------|-------------------|
|                                    | <b>Carrying</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Fair Value</b> |
| <b>December 31, 2012</b>           | <b>Value</b>    | <b>Inputs</b>  | <b>Inputs</b>  | <b>Inputs</b>  |                   |
| Financial Assets:                  |                 |                |                |                |                   |
| Cash and cash equivalents          | \$ 14,992       | \$14,992       | \$ ---         | \$ ---         | \$ 14,992         |
| Federal Home Loan Bank stock       | \$ 18,189       | \$ ---         | \$ 18,189      | \$ ---         | \$ 18,189         |
| Loans, net                         | \$806,907       | \$ ---         | \$ ---         | \$822,675      | \$822,675         |
| Interest receivable                | \$ 4,502        | \$ 4,502       | \$ ---         | \$ ---         | \$ 4,502          |
| Financial liabilities:             |                 |                |                |                |                   |
| Deposits (with no stated maturity) | \$425,205       | \$ ---         | \$425,205      | \$ ---         | \$425,205         |
| Time deposits                      | \$370,560       | \$ ---         | \$377,427      | \$ ---         | \$377,427         |
| Borrowings                         | \$371,567       | \$ ---         | \$377,510      | \$ ---         | \$377,510         |
| Interest payable                   | \$ 684          | \$ 684         | \$ ---         | \$ ---         | \$ 684            |

## Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's discussion and analysis, which follows, focuses on the factors affecting the Company's consolidated results of operations for the three months ended March 31, 2013, and 2012, and financial condition at March 31, 2013, and December 31, 2012, and where appropriate, factors that may affect future financial performance. The following

discussion and analysis of financial condition and results of operations of the Company and its subsidiaries should be read in conjunction with the consolidated financial statements and notes thereto, and selected financial and statistical information appearing elsewhere in this report on Form 10-Q.

Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation.

Unless otherwise noted, all dollars are expressed in thousands except share data.

***Use of Non-GAAP Financial Measures:*** Certain information discussed below is presented on a fully taxable equivalent basis. Specifically, included in interest income in the first quarter of 2013 and 2012 was \$817 and \$732, respectively, of tax-exempt interest income from certain investment securities and loans. An amount equal to the tax benefit derived from this tax exempt income has been added back to the interest income totals discussed in certain sections of this Management's Discussion and Analysis, representing tax equivalent adjustments of \$400 and \$357 in the first quarter of 2013 and 2012, respectively, and which increased net interest income accordingly. The analysis of net interest income tables included in this report on Form 10-Q provide a reconciliation of tax equivalent financial information to the Company's consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles.

Management believes the disclosure of tax equivalent net interest income information improves the clarity of financial analysis, and is particularly useful to investors in understanding and evaluating the changes and trends in the Company's results of operations. Other financial institutions commonly present net interest income on a tax equivalent basis. This adjustment is considered helpful in the comparison of one financial institution's net interest income to that of another institution, as each will have a different proportion of tax-exempt interest from their earning asset portfolios. Moreover, net interest income is a component of a second financial measure commonly used by financial institutions, net interest margin, which is the ratio of net interest income to average earning assets. For purposes of this measure as well, other financial

institutions generally use tax equivalent net interest income to provide a better basis of comparison from institution to institution. The Company follows these practices.

## **FORWARD LOOKING STATEMENTS DISCLAIMER**

Certain statements, as well as certain other discussions contained in this quarterly report on Form 10-Q, or incorporated herein by reference, contain statements which may be considered to be forward-looking within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Readers can identify these forward-looking statements by the use of words like "strategy," "expects," "plans," "believes," "will," "estimates," "intends," "projects," "goals," "targets," and other words of similar meaning. Readers can also identify them by the fact that they do not relate strictly to historical or current facts.

Investors are cautioned that forward-looking statements are inherently uncertain. Forward-looking statements include, but are not limited to, those made in connection with estimates with respect to the future results of operation, financial condition, and the business of the Company which are subject to change based on the impact of various factors that could cause actual results to differ materially from those projected or suggested due to certain risks and uncertainties. Those factors include but are not limited to:

- (i) The Company's success is dependent to a significant extent upon general economic conditions in Maine, and Maine's ability to attract new business, as well as factors that affect tourism, a major source of economic activity in the Company's immediate market areas;
- (ii) The Company's earnings depend to a great extent on the level of net interest income (the difference between interest income earned on loans and investments and the interest expense paid on deposits and borrowings) generated by the Company's wholly-owned banking subsidiary, Bar Harbor Bank & Trust (the Bank), and thus the Company's results of operations may be adversely affected by increases or decreases in interest rates;
- (iii) The banking business is highly competitive and the profitability of the Company depends on the Bank's ability to attract loans and deposits in Maine, where the Bank competes with a variety of traditional banking and non-traditional institutions, such as credit unions and finance companies;
- (iv) A significant portion of the Bank's loan portfolio is comprised of commercial loans and loans secured by real estate, exposing the Company to the risks inherent in financings based upon analysis of credit risk, the value of underlying collateral, and other intangible factors which are considered in making commercial loans and, accordingly, the Company's profitability may be negatively impacted by judgment errors in risk analysis, by loan defaults, and the ability of certain borrowers to repay such loans during a downturn in general economic conditions;
- (v)

Adverse changes in repayment performance and fair value of underlying residential mortgage loan collateral, that differ from the Company's current estimates, could change the Company's expectations that it will recover the amortized cost of its private label mortgage backed securities portfolio and/or its conclusion that such securities were not other-than temporarily impaired as of the date of this report;

- (vi) Our allowance for loan losses may be adversely impacted by a variety of factors, including, but not limited to, the performance of the Company's loan portfolio, the economy, changes in interest rates, and the view of regulatory authorities toward loan classifications;
- (vii) Significant changes in the Company's internal controls, or internal control failures;
- (viii) Acts or threats of terrorism and actions taken by the United States or other governments as a result of such threats, including military action, could further adversely affect business and economic conditions in the United States generally and in the Company's markets, which could have an adverse effect on the Company's financial performance and that of borrowers and on the financial markets and the price of the Company's common stock;
- (ix) Significant changes in the extensive laws, regulations, and policies governing bank holding companies and their subsidiaries could alter the Company's business environment or affect its operations;
- (x) Changes in general, national, international, regional or local economic conditions and credit markets which are less favorable than those anticipated by Company management that could impact the Company's securities portfolio, quality of credits, or the overall demand for the Company's products or services; and
- (xi) The Company's success in managing the risks involved in all of the foregoing matters.

Readers should carefully review all of these factors as well as the risk factors set forth in Item 1A- Risk Factors, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. There may be other risk factors that could cause differences from those anticipated by management.

The forward-looking statements contained herein represent the Company's judgment as of the date of this quarterly report on Form 10-Q and the Company cautions readers not to place undue reliance on such statements. The Company disclaims any obligation to publicly update or revise any forward-looking statement contained in the succeeding discussion, or elsewhere in this quarterly report on Form 10-Q, except to the extent required by federal securities laws.

## **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

The Company's significant accounting policies are more fully enumerated in Note 1 to the Consolidated Financial Statements included in Item 8 of its December 31, 2012, report on Form 10-K. The reader of the financial statements should review these policies to gain a greater understanding of how the Company's financial performance is reported.

Management's discussion and analysis of the Company's financial condition and results of operations are based on the Consolidated Financial Statements, which are prepared in accordance with U.S. generally accepted accounting principles. The preparation of such financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Management evaluates its estimates on an ongoing basis. Management bases its estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis in making judgments about the carrying values of assets that are not readily apparent from other sources. Actual results could differ from the amount derived from management's estimates and assumptions under different assumptions or conditions. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, other than temporary impairment on securities, income tax estimates, and the evaluation of intangible assets. The use of these estimates is more fully described in Part I, Item 1, Note 2 of the consolidated financial statements in this quarterly report on Form 10-Q.

## SUMMARY FINANCIAL RESULTS

For the three months ended March 31, 2013, the Company reported net income of \$3,216, compared with \$3,163 in the first quarter of 2012, representing an increase of \$53, or 1.7%. The Company's diluted earnings per share amounted to \$0.82 for the quarter compared with \$0.81 in the first quarter of 2012, representing an increase of \$0.01, or 1.2%.

The Company's annualized return on average shareholders' equity ( ROE ) amounted to 10.14% for the quarter, compared with 10.51% in the first quarter of 2012. The Company's first quarter return on average assets ( ROA ) amounted to 1.00%, compared with 1.07% in the first quarter of 2012.

As more fully enumerated in the following management discussion and analysis, the Company's first quarter results were highlighted by further improvements in credit quality, continued commercial loan growth, higher levels of non-interest income and a strengthening of its capital ratios. While the Company's first quarter net interest income was up \$272 or 3.0% compared with the first quarter of 2012, the net interest margin posted a fifteen basis point decline as earning asset yields declined faster than the cost of interest bearing liabilities. The Company continued to focus on the management of its operating expenses during the current quarter, posting an efficiency ratio of 55.3%.

As previously announced, on August 10, 2012, the Bank acquired substantially all assets and assumed certain liabilities including all deposits of Border Trust Company ( Border Trust ), a subsidiary of Border Bancshares, Inc., headquartered in Augusta, Maine. The Bank acquired \$38,520 of deposits and \$33,606 in loans, as well as three branch offices (two of which were leased) located in Kennebec and Sagadahoc Counties. The Bank paid a core deposit premium of 3.85%, or \$1,115, and purchased the loan portfolio, excluding selected non-performing loans, at a discount of 2.16%, or \$749. In connection with this transaction, the Bank recorded estimated goodwill of \$1,777 and an estimated core deposit intangible of \$783, or 2.7% of core deposits.

## RESULTS OF OPERATIONS

### Net Interest Income

Net interest income is the principal component of the Company's income stream and represents the difference or spread between interest generated from earning assets and the interest expense paid on deposits and borrowed funds. Net interest income is entirely generated by the Bank. Fluctuations in market interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income.

**Total Net Interest Income:** For the three months ended March 31, 2013, net interest income on a tax equivalent basis amounted to \$9,689, compared with \$9,374 in the first quarter of 2012, representing an increase of \$315, or 3.4%. The increase in first quarter 2013 tax-equivalent net interest income compared with the first quarter of 2012 was attributed to average earning asset growth of \$103,287 or 9.0%, as the net interest margin declined fifteen basis points.

Factors contributing to the changes in net interest income and the net interest margin are more fully enumerated in the following discussion and analysis.

**Net Interest Income Analysis:** The following tables summarize the Company's average balance sheets and components of net interest income, including a reconciliation of tax equivalent adjustments, for the three months ended March 31, 2013, and 2012:

**AVERAGE BALANCE SHEET AND  
ANALYSIS OF NET INTEREST INCOME  
THREE MONTHS ENDED  
MARCH 31, 2013 AND 2012**

|  | 2013               |          |                             | 2012               |          |                             |
|--|--------------------|----------|-----------------------------|--------------------|----------|-----------------------------|
|  | Average<br>Balance | Interest | Weighted<br>Average<br>Rate | Average<br>Balance | Interest | Weighted<br>Average<br>Rate |
| <b>Interest Earning Assets:</b>  |                    |          |                             |                    |          |                             |
| Loans (1,3)  | \$ 815,755         | \$ 9,239 | 4.59%                       | \$ 743,710         | \$ 8,911 | 4.82%                       |
| Securities (2,3)   | 411,677            | 3,504    | 3.45%                       | 382,380            | 4,013    | 4.22%                       |
| Federal Home Loan Bank stock   | 18,161             | 22       | 0.49%                       | 16,216             | 20       | 0.50%                       |
| Fed funds sold, money market funds,<br>and time<br>deposits with other banks | 1                  | ---      | 0.00%                       | 1                  | ---      | 0.00%                       |
| Total Earning Assets   | 1,245,594          | 12,765   | 4.16%                       | 1,142,307          | 12,944   | 4.56%                       |
| <b>Non-Interest Earning Assets:</b>  |                    |          |                             |                    |          |                             |
| Cash and due from banks  | 3,640              |          |                             | 3,324              |          |                             |
| Allowance for loan losses  | (8,280)            |          |                             | (8,367)            |          |                             |
| Other assets (2)   | 58,836             |          |                             | 55,074             |          |                             |
| Total Assets   | \$ 1,299,790       |          |                             | \$ 1,192,338       |          |                             |
| <b>Interest Bearing Liabilities:</b>   |                    |          |                             |                    |          |                             |
| Deposits   | \$ 716,222         | \$ 1,702 | 0.96%                       | \$ 665,109         | \$ 1,955 | 1.18%                       |
| Borrowings   | 382,710            | 1,374    | 1.46%                       | 340,616            | 1,615    | 1.91%                       |
| Total Interest Bearing Liabilities   | 1,098,932          | 3,076    | 1.14%                       | 1,005,725          | 3,570    | 1.43%                       |
| Rate Spread  |                    |          | 3.02%                       |                    |          | 3.13%                       |
| <b>Non-Interest Bearing Liabilities:</b>                                     |                    |          |                             |                    |          |                             |
| Demand and other non-interest bearing<br>deposits                            | 66,702             |          |                             | 59,510             |          |                             |
| Other liabilities  | 5,586              |          |                             | 6,096              |          |                             |
| Total Liabilities  | 1,171,220          |          |                             | 1,071,331          |          |                             |
| Shareholders' equity   | 128,570            |          |                             | 121,007            |          |                             |
|  | \$ 1,299,790       |          |                             | \$ 1,192,338       |          |                             |

Total Liabilities and Shareholders'  
Equity

|   |          |              |          |              |
|---|----------|--------------|----------|--------------|
| Net interest income and net interest margin (3) | 9,689    | <b>3.15%</b> | 9,374    | <b>3.30%</b> |
| Less: Tax Equivalent adjustment                 | (400)    |              | (357)    |              |
| Net Interest Income                             | \$ 9,289 | <b>3.02%</b> | \$ 9,017 | <b>3.17%</b> |

(1)

*For purposes of these computations, non-accrual loans are included in average loans.*

(2)

*For purposes of these computations, unrealized gains (losses) on available for sale securities are recorded in other assets.*

(3)

*For purposes of these computations, interest income, net interest income and net interest margin are reported on a tax equivalent basi*

s.

***Net Interest Margin:*** The net interest margin, expressed on a tax equivalent basis, represents the difference between interest and dividends earned on interest-earning assets and interest paid to depositors and other creditors, expressed as a percentage of average earning assets.

The net interest margin is determined by dividing tax equivalent net interest income by average interest-earning assets. The interest rate spread represents the difference between the average tax equivalent yield earned on interest earning-assets and the average rate paid on interest bearing liabilities. The net interest margin is generally higher than the interest rate spread due to the additional income earned on those assets funded by non-interest bearing liabilities, primarily demand deposits and shareholders' equity.

For the three months ended March 31, 2013, the tax equivalent net interest margin amounted to 3.15%, compared with 3.30% in the first quarter of 2012, representing a decline of fifteen basis points. The decline in the net interest margin was attributed to earning asset yields, which declined faster than the Bank's cost of funds. Specifically, the yield on earning assets declined 40 basis points to 4.16% while the rate paid on interest bearing liabilities declined 29 basis points to 1.14%.

The following table summarizes the net interest margin components, on a quarterly basis, over the past two years. Factors contributing to the changes in the net interest margin are further enumerated in the following discussion and analysis.

**NET INTEREST MARGIN ANALYSIS**  
**FOR QUARTER ENDED**

| <b>WEIGHTED AVERAGE RATES</b>   | <b>2013</b> | <b>2012</b> |          |          |          | <b>2011</b> |          |          |
|---|-------------|-------------|----------|----------|----------|-------------|----------|----------|
| <b>Quarter:</b>   | <b>1</b>    | <b>4</b>    | <b>3</b> | <b>2</b> | <b>1</b> | <b>4</b>    | <b>3</b> | <b>2</b> |
| <b>Interest Earning Assets:</b>   |             |             |          |          |          |             |          |          |
| Loans (1,3)   | 4.59%       | 4.71%       | 4.72%    | 4.64%    | 4.82%    | 4.88%       | 4.83%    | 4.86%    |
| Securities (2,3)  | 3.45%       | 3.72%       | 3.72%    | 3.96%    | 4.22%    | 4.29%       | 4.58%    | 4.78%    |
| Federal Home Loan Bank stock  | 0.49%       | 0.50%       | 0.49%    | 0.49%    | 0.50%    | 0.30%       | 0.27%    | 0.30%    |
| Fed Funds sold, money market funds,<br>and time deposits with other banks | 0.00%       | 0.00%       | 0.00%    | 0.00%    | 0.00%    | 0.00%       | 0.00%    | 0.00%    |
| Total Earning Assets  | 4.16%       | 4.32%       | 4.32%    | 4.35%    | 4.56%    | 4.61%       | 4.68%    | 4.77%    |
| <b>Interest Bearing Liabilities:</b>                                      |             |             |          |          |          |             |          |          |
| Deposits  | 0.96%       | 1.05%       | 1.07%    | 1.13%    | 1.18%    | 1.25%       | 1.27%    | 1.30%    |
| Borrowings  | 1.46%       | 1.63%       | 1.72%    | 1.69%    | 1.91%    | 2.38%       | 2.57%    | 2.69%    |
| Total Interest Bearing Liabilities  | 1.14%       | 1.24%       | 1.28%    | 1.33%    | 1.43%    | 1.58%       | 1.65%    | 1.74%    |
| Rate Spread   | 3.02%       | 3.08%       | 3.04%    | 3.02%    | 3.13%    | 3.03%       | 3.03%    | 3.03%    |
| Net Interest Margin (3)   | 3.15%       | 3.23%       | 3.20%    | 3.17%    | 3.30%    | 3.23%       | 3.24%    | 3.23%    |
| Net Interest Margin without   |             |             |          |          |          |             |          |          |
| Tax Equivalent Adjustments  | 3.02%       | 3.08%       | 3.06%    | 3.04%    | 3.17%    | 3.11%       | 3.12%    | 3.09%    |

(1) For purposes of these computations, non-accrual loans are included in average loans.

*(2) For purposes of these computations, unrealized gains (losses) on available for sale securities are recorded in other assets.*

*(3) For purposes of these computations, interest income, net interest income and net interest margin are reported on a tax equivalent basis.*

For the three months ended March 31, 2013, the weighted average yield on average earning assets amounted to 4.16%, compared with 4.56% for the same quarter in 2012, representing a decline of 40 basis points. This decline largely resulted from the replacement of accelerated cash flows from the Bank's mortgage-backed securities portfolio along with the purchase of additional securities during a period of historically low interest rates. The decline was also attributed to the origination and competitive re-pricing of certain commercial loans, as well as residential mortgage loan refinancing activity during a period of historically low interest rates.

For the three months ended March 31, 2013, the weighted average cost of interest bearing liabilities amounted to 1.14%, compared with 1.43% for the same quarter in 2012, representing a decline of 29 basis points. This decline principally reflected the ongoing re-pricing of maturing time deposits and borrowings, combined with the lowering of interest rates on certain of the Bank's core deposit products.

**Interest and Dividend Income:** For the three months ended March 31, 2013, total interest and dividend income on a tax-equivalent basis amounted to \$12,765, compared with \$12,944 in the first quarter of 2012, representing a decline of \$179, or 1.4%. The decline in interest and dividend income was principally attributed to a 40 basis point decline in the weighted average earning asset yield, largely offset by earning asset growth of \$103,287, or 9.0%.

For the three months ended March 31, 2013, tax-equivalent interest income from the securities portfolio amounted to \$3,504, representing a decline of \$509, or 12.7%, compared with the first quarter of 2012. The decline in interest income from securities was principally attributed to a 77 basis point decline in the weighted average securities portfolio yield to 3.45%, offset in part by a \$29,297, or 7.7% increase in total average securities, compared with the first quarter of 2012. The decline in the weighted average securities yield was largely attributed to the ongoing replacement of accelerated mortgage-backed securities cash flows in a historically low interest rate environment combined with incremental securities purchases at low prevailing market yields. Accelerated cash flows were principally attributed to increased securitized loan refinancing activity driven by historically low interest rates, a variety of government stimulus programs, quantitative easing efforts by the Federal Reserve, as well as continuing credit defaults.

For the three months ended March 31, 2013, tax-equivalent interest income from the loan portfolio amounted to \$9,239, representing an increase of \$328, or 3.7% compared with the first quarter of 2012. The increased income from the loan portfolio was attributed to a \$72,045 or 9.7% increase in total average loans, but was largely offset by a 23 basis point decline in the weighted average yield to 4.59%, compared with the first quarter of 2012. The decline in the weighted average loan yield principally reflected the origination and competitive re-pricing of certain commercial loans, as well as elevated levels of residential mortgage loan refinancing activity during a period of historically low interest rates.

As depicted on the rate/volume analysis table below, comparing the first quarter of 2013 with the same quarter in 2012, the impact of the lower weighted average earning asset yield contributed \$1,351 to the decline in total tax-equivalent interest income, which was largely offset by \$1,172 attributed to the increased volume of total average earning assets.

**Interest Expense:** For the three months ended March 31, 2013, total interest expense amounted to \$3,076, compared with \$3,570 in the first quarter of 2012, representing a decline of \$494, or 13.8%. The decline in interest expense was principally attributed to a 29 basis point decline in the weighted average cost of interest bearing liabilities, the impact of which was largely offset by a \$93,207 or 9.3% increase in total average interest bearing liabilities, compared with the first quarter of 2012.

The decline in the first quarter weighted average cost of interest bearing liabilities compared with the same quarter in 2012 was principally attributed to prevailing, historically low short-term and long-term market interest rates, with maturing time deposits and borrowings being added or replaced at a lower cost and other interest bearing deposits re-pricing into the lower interest rate environment. For the three months ended March 31, 2013, the total weighted average cost of interest bearing liabilities amounted to 1.14%, compared with 1.43% for the same quarter in 2012, representing a decline of 29 basis points. The weighted average cost of interest bearing deposits declined 22 basis points to 0.96%, compared with the first quarter of 2012, while the weighted average cost of borrowed funds declined 45 basis points to 1.46%.

As depicted on the rate/volume analysis table below, comparing the first quarter of 2013 with the same quarter in 2012, the impact of the lower weighted average rate paid on interest bearing liabilities contributed \$844 to the decline in interest expense, offset in part by \$350 attributed to the increased volume of interest bearing liabilities.

**Rate/Volume Analysis:** The following tables set forth a summary analysis of the relative impact on net interest income of changes in the average volume of interest earning assets and interest bearing liabilities, and changes in average rates on such assets and liabilities. The income from tax-exempt assets has been adjusted to a fully tax equivalent basis, thereby allowing uniform comparisons to be made. Because of the numerous simultaneous volume and rate changes during the periods analyzed, it is not possible to precisely allocate changes to volume or rate. For presentation purposes, changes which are not solely due to volume changes or rate changes have been allocated to these categories in proportion to the relationships of the absolute dollar amounts of the change in each.

**ANALYSIS OF VOLUME AND RATE CHANGES ON NET INTEREST INCOME****THREE MONTHS ENDED MARCH 31, 2013 AND 2012****INCREASES (DECREASES) DUE TO:**

|  | <b>Average</b> | <b>Average</b>   | <b>Total</b>   |
|--|----------------|------------------|----------------|
|  | <b>Volume</b>  | <b>Rate</b>      | <b>Change</b>  |
| Loans (1,3)  | \$ 862         | \$ (534)         | \$ 328         |
| Securities (2,3)   | 308            | (817)            | (509)          |
| Federal Home Loan Bank stock   | 2              | ---              | 2              |
| Fed funds sold, money market funds, and time deposits with other banks | ---            | ---              | ---            |
| <b>TOTAL EARNING ASSETS</b>  | <b>\$1,172</b> | <b>\$(1,351)</b> | <b>\$(179)</b> |
| Interest bearing deposits  | 150            | (403)            | (253)          |
| Borrowings   | 200            | (441)            | (241)          |
| <b>TOTAL INTEREST BEARING LIABILITIES</b>                              | <b>\$ 350</b>  | <b>\$ (844)</b>  | <b>\$(494)</b> |
| <b>NET CHANGE IN NET INTEREST INCOME</b>                               | <b>\$ 822</b>  | <b>\$ (507)</b>  | <b>\$ 315</b>  |

*(1)**For purposes of these computations, non-accrual loans are included in average loans.**(2)**For purposes of these computations, unrealized gains (losses) on available for sale securities are recorded in other assets.**(3)**For purposes of these computations, net interest income and net interest margin are reported on a tax equivalent basis.*

## **Provision for Loan Losses**

The provision for loan losses (the provision) reflects the amount necessary to maintain the allowance for loan losses at a level that, in management's judgment, is appropriate for the amount of inherent risk of probable loss in the Bank's current loan portfolio.

The credit quality of the Bank's loan portfolio continued to improve during the three months ended March 31, 2013. This improvement was highlighted by a \$1,275 or 12.9% decline in non-performing loans and a \$413 or 4.0% decline in potential problem loans, compared with December 31, 2012. During the three months ended March 31, 2013, the Bank experienced a moderate level of loan loss experience, with total net loan charge-offs amounting to \$395, or annualized net charge-offs to average loans outstanding of 0.19%, compared with \$315 and 0.17% in the first quarter of 2012, respectively.

For the three months ended March 31, 2013, the Bank recorded a provision of \$353, compared with \$415 in the first quarter of 2012, representing a decline of \$62, or 14.9%. The provision recorded for the three months ended March 31, 2013, was largely driven by the Bank's charge-off experience, as the overall credit quality of the loan portfolio remained relatively stable and the growth of the loan portfolio slowed.

Refer below to Item 2 of this Part I, Financial Condition, Loans, *Non-Performing Loans, Potential Problem Loans and Allowance for Loan Losses*, in this report on Form 10-Q for further discussion and analysis related to the provision for loan losses.

## **Non-interest Income**

For the three months ended March 31, 2013, total non-interest income amounted to \$1,950, compared with \$1,700 for the same quarter in 2012, representing an increase of \$250, or 14.7%.

Factors contributing to the changes in non-interest income are enumerated in the following discussion and analysis.

***Trust and Other Financial Services:*** Income from trust and other financial services is principally derived from fee income based on a percentage of the fair market value of client assets under management and held in custody and, to a lesser extent, revenue from brokerage services conducted through Bar Harbor Financial Services, an independent third-party broker.

For the three months ended March 31, 2013, trust and other financial service fees amounted to \$906, compared with \$779 for the same quarter in 2012, representing an increase of \$127, or 16.3%. This increase was principally attributed to retail brokerage activities, the revenue from which was up \$106 compared with the first quarter of 2012.

Reflecting new client relationships and improvement in the equity markets, quarter-end assets under management stood at \$369,880, up from \$355,461 at year end 2012 and representing an increase of \$14,419 or 4.1% compared with March 31, 2012.

***Service Charges on Deposit Accounts:*** For the three months ended March 31, 2013, income from service charges on deposit accounts amounted to \$295, compared with \$250 for the same quarter of 2012, representing an increase of \$45, or 18.0%. The increase in service charges on deposit accounts was largely attributed to customer overdraft fee increases instituted in the third quarter of 2012 as well as increased overdraft activity.

**Credit and Debit Card Service Charges and Fees:** For the three months ended March 31, 2013, income generated from credit and debit card service charges and fees amounted to \$336, compared with \$316 for the first quarter of 2012, representing an increase of \$20, or 6.3%. This increase was largely attributed to continued growth of the Bank's retail deposit base, higher levels of merchant credit card processing volumes, and continued success with a program that offers rewards for certain debit card transactions.

**Net Securities Gains:** For the three months ended March 31, 2013, total net securities gains amounted to \$265, compared with \$567 for the first quarter of 2012, representing a decline of \$302, or 53.3%. The net realized securities gains recorded in the first quarter of 2013 were comprised of realized gains of \$273, offset by realized losses of \$8. The net realized securities gains recorded in the first quarter of 2012 were comprised of realized gains of \$573, offset by realized losses of \$6.

**Net Other-than-temporary Impairment Losses Recognized in Earnings:** For the three months ended March 31, 2013, there were no OTTI losses recognized in earnings compared with \$344 for the same quarter of 2012.

During the three months ended March 31, 2012, the Company determined that certain private-label mortgage-backed securities were other-than-temporarily impaired ( OTTI ), because the Company could no longer conclude that it was probable it would recover all of the principal and interest on these securities. The credit losses principally reflected an increase in the loss severity and constant default rate estimates of the underlying residential mortgage loan collateral, resulting from seriously depressed real estate values, extended foreclosure and collateral liquidation timelines, and depressed economic conditions overall. The OTTI losses recorded in the first quarter of 2012 represented management's best estimate of credit losses or additional credit losses on the residential mortgage loan collateral underlying these securities. The credit losses were previously recorded, net of taxes, in unrealized gains or losses on securities available for sale within accumulated other comprehensive income or loss, a component of total shareholders' equity on the Company's consolidated balance sheet.

Further information regarding impaired securities, other-than-temporarily impaired securities, and evaluation of securities for impairment is incorporated by reference to Notes 2 and 5 of the unaudited consolidated financial statements in Part I, Item 1 of this quarterly report on Form 10-Q.

### **Non-interest Expense**

For the three months ended March 31, 2013, total non-interest expense amounted to \$6,307, compared with \$5,808 in the first quarter of 2012, representing an increase of \$499, or 8.6%.

Factors contributing to the changes in non-interest expense are more fully enumerated in the following discussion and analysis.

**Salaries and Employee Benefits:** For the three months ended March 31, 2013, total salaries and employee benefits expense amounted to \$3,607, compared with \$3,182 in the first quarter of 2012, representing an increase of \$425, or 13.4%. The increase in salaries and employee benefits was attributed to a variety of factors including normal increases in base salaries, increased costs of contributory health insurance, higher levels of employee incentive compensation, as well as changes in staffing levels and mix. The increase in salaries and employee benefits also reflects the Bank's previously reported acquisition of three branch offices in the third quarter of 2012. First quarter salaries and benefits also included \$96 in expenses related to certain restricted stock awards to the Company's Board of Directors, compared with none in the first quarter of 2012.

**Occupancy Expense:** For the three months ended March 31, 2013, total occupancy expense amounted to \$484, compared with \$405 for the same quarter in 2012, representing an increase of \$79, or 19.5%. This increase was largely attributed to the three new branch office locations acquired in connection with the Border Trust transaction, which was consummated in the third quarter of 2012. The increase in occupancy expense was also attributed to the Bank's substantial reconfiguration of its Ellsworth campus, including the replacement of its Ellsworth retail banking office, which was put in service in the third quarter of 2012.

**Furniture and Equipment Expense:** For the three months ended March 31, 2013, total furniture and equipment expense amounted to \$510, compared with \$415 for the same quarter in 2012, representing an increase of \$95, or 22.9%. Approximately \$66 of this increase was attributed to the three new branch office locations acquired in the third quarter of 2012. The increase in furniture and expense was also attributed to the Bank's substantial reconfiguration of its Ellsworth campus, including the replacement of its Ellsworth retail banking office, which was put in service in the third quarter of 2012.

**FDIC Assessments:** For the three months ended March 31, 2013, total FDIC insurance assessments amounted to \$196, compared with \$185 for the same quarter of 2012, representing an increase of \$11, or 6.0%. This increase was largely attributed to higher levels of insured deposits.

**Other Operating Expenses:** For the three months ended March 31, 2013, total other operating expenses amounted to \$1,414, compared with \$1,533 for the same quarter of 2012, representing a decline of \$119, or 7.8%. This decline was principally attributed to lower levels of loan collection and other real estate owned expenses, as well as fees for professional services.

## **Efficiency Ratio**

The Company's efficiency ratio measures the relationship of operating expenses to revenues. The efficiency ratio is calculated by dividing non-interest operating expenses by the sum of tax-equivalent net interest income and non-interest income other than net securities gains, other-than-temporary impairments, and other significant non-recurring expenses, including the non-recurring expenses related to the Border Trust transaction. For the three months ended March 31, 2013, the Company's efficiency ratio amounted to 55.3%, compared with 53.4% for the same quarter of 2012.

## **Income Taxes**

For the three months ended March 31, 2013, total income taxes amounted to \$1,363, compared with \$1,331 for the same quarter of 2012, representing an increase of \$32, or 2.4%.

The Company's effective tax rates for the three months ended March 31, 2013, amounted to 29.8%, compared with 29.6% for the same quarter of 2012. The income tax provisions for these periods were less than the expense that would result from applying the federal statutory rate of 35% to income before income taxes, principally because of the impact of tax exempt interest income on certain investment securities, loans and bank owned life insurance.

Fluctuations in the Company's effective tax rate are generally attributed to changes in the relationship between non-taxable income and non-deductible expense, and income before income taxes, during any given reporting period.

## **FINANCIAL CONDITION**

### **Total Assets**

The Company's assets principally consist of loans and securities, which at March 31, 2013, represented 62.5% and 32.4% of total assets, compared with 62.6% and 32.1% at December 31, 2012, respectively.

At March 31, 2013, the Company's total assets amounted to \$1,307,252, compared with \$1,302,935 at December 31, 2012, representing an increase of \$4,317, or 0.3%.

## Securities

The securities portfolio is comprised of mortgage-backed securities ( MBS ) issued by U.S. Government agencies, U.S. Government sponsored enterprises, and other non-agency, private label issuers. The portfolio also includes tax-exempt obligations of state and political subdivisions, and debt obligations of other U.S. Government sponsored enterprises.

Bank management considers securities as a relatively attractive means to effectively leverage the Bank's strong capital position, as securities are typically assigned a significantly lower risk weighting compared with the Bank's other earning assets for the purpose of calculating the Bank's and the Company's risk-based capital ratios. The overall objectives of the Bank's strategy for the securities portfolio include maintaining appropriate liquidity reserves, diversifying earning assets, managing interest rate risk, leveraging the Bank's strong capital position, and generating acceptable levels of net interest income.

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Securities available for sale represented 100% of total securities at March 31, 2013, and December 31, 2012. Securities available for sale are reported at their fair value with unrealized gains or losses, net of taxes, excluded from earnings but shown separately as a component of shareholders' equity. At March 31, 2013, total net unrealized securities gains amounted to \$8,891, compared with net unrealized gains of \$12,271 at December 31, 2012. The decline in unrealized gains principally resulted from changes in market yields and pricing spreads compared with year end 2012, as well as first quarter realized gains on the sale of certain securities.

**Total Securities:** At March 31, 2013, total securities amounted to \$423,914, compared with \$418,040 at December 31, 2012, representing an increase of \$5,874, or 1.4%. Securities purchased during the three months ended March 31, 2013, consisted of MBS issued and guaranteed by U.S. Government agencies and sponsored-enterprises, and to a lesser extent, obligations of states and political subdivisions thereof (municipal securities).

The following tables summarize the securities available for sale portfolio as of March 31, 2013, and December 31, 2012:

| March 31, 2013   | Gross     |            | Gross      |            |
|--|-----------|------------|------------|------------|
|  | Amortized | Unrealized | Unrealized | Estimated  |
| Available for Sale:                                      | Cost      | Gains      | Losses     | Fair Value |
| Mortgage-backed securities:                              |           |            |            |            |
| US Government-sponsored enterprises                      | \$244,075 | \$ 7,008   | \$ 2,149   | \$248,934  |
| US Government agency                                     | 87,716    | 1,810      | 259        | 89,267     |
| Private label  | 7,416     | 733        | 275        | 7,874      |
| Obligations of states and political subdivisions thereof | 75,816    | 2,932      | 909        | 77,839     |
| Total  | \$415,023 | \$12,483   | \$3,592    | \$423,914  |

| December 31, 2012  | Gross     |            | Gross      |            |
|--|-----------|------------|------------|------------|
|  | Amortized | Unrealized | Unrealized | Estimated  |
| Available for Sale:                                      | Cost      | Gains      | Losses     | Fair Value |
| Mortgage-backed securities:                              |           |            |            |            |
| US Government-sponsored enterprises                      | \$238,974 | \$ 7,913   | \$1,064    | \$245,823  |
| US Government agency                                     | 82,397    | 2,080      | 216        | 84,261     |
| Private label  | 8,063     | 571        | 521        | 8,113      |
| Obligations of states and political subdivisions thereof | 76,335    | 4,040      | 532        | 79,843     |
| Total  | \$405,769 | \$14,604   | \$2,333    | \$418,040  |

**Impaired Securities:** The securities portfolio contains certain securities where amortized cost exceeds fair value, which at March 31, 2013, amounted to an excess of \$3,592, or 0.8% of the amortized cost of the total securities

portfolio. At December 31, 2012 this amount represented an excess of \$2,333, or 0.6% of the total securities portfolio. As of March 31, 2013, unrealized losses on securities in a continuous unrealized loss position more than twelve-months amounted to \$618, compared with \$744 at December 31, 2012.

As a part of the Company's ongoing security monitoring process, the Company identifies securities in an unrealized loss position that could potentially be other-than-temporarily impaired. If a decline in the fair value of an available for sale security is judged to be other-than-temporary, a charge is recorded in pre-tax earnings equal to the estimated credit losses inherent in the security.

Further information regarding impaired securities, other-than-temporarily impaired securities and evaluation of securities for impairment is incorporated by reference to above Notes 2 and 5 of the interim unaudited consolidated financial statements in Part I, Item 1 of this report on Form 10-Q.

## Federal Home Loan Bank Stock

The Bank is a member of the Federal Home Loan Bank of Boston (the FHLB). The FHLB is a cooperatively owned wholesale bank for housing and finance in the six New England states. Its mission is to support the residential mortgage and community-development lending activities of its members, which include over 450 financial institutions across New England. As a requirement of membership in the FHLB, the Bank must own a minimum required amount of FHLB stock, calculated periodically based primarily on its level of borrowings from the FHLB. The Bank uses the FHLB for most of its wholesale funding needs.

At March 31, 2013, the Bank's investment in FHLB stock totaled \$18,108, compared with \$18,189 at December 31, 2012, representing a decline of \$81, or 0.4%.

FHLB stock is a non-marketable equity security and therefore is reported at cost, which generally equals par value. Furthermore, the ratio of the FHLB's market value of equity to its par value of capital stock was 112% at March 31, 2013, compared with 108% at December 31, 2012. Shares held in excess of the minimum required amount are generally redeemable at par value.

The Company periodically evaluates its investment in FHLB stock for impairment based on, among other things, the capital adequacy of the FHLB and its overall financial condition. The FHLB recently reported that it remained in compliance with all regulatory capital ratios as of March 31, 2013, and was classified as adequately capitalized by its regulator, the Federal Housing Finance Agency, based on the FHLB's financial information at December 31, 2012. Based on the capital adequacy, liquidity position and sustained profitability of the FHLB, management believes there is no impairment related to the carrying amount of the Bank's FHLB stock as of March 31, 2013. The Bank will continue to monitor its investment in FHLB stock.

**Loans**

**Total Loans:** At March 31, 2013, total loans stood at \$817,226, compared with \$815,004 at December 31, 2012, representing an increase of \$2,222, or 0.3%.

The loan portfolio is primarily secured by real estate in the counties of Hancock, Washington and Knox, Kennebec, and Sagadahoc, Maine. The following table summarizes the components of the Bank's loan portfolio as of the dates indicated.

**LOAN PORTFOLIO SUMMARY**

|  | <b>March 31,</b> | <b>December 31,</b> |
|--|------------------|---------------------|
|  | <b>2013</b>      | <b>2012</b>         |
| Commercial real estate mortgages             | \$315,661        | \$324,493           |
| Commercial and industrial                    | 78,043           | 59,373              |
| Commercial construction and land development | 15,523           | 22,120              |
| Agricultural and other loans to farmers      | 26,399           | 24,922              |
| Total commercial loans                       | 435,626          | 430,908             |
| Residential real estate mortgages            | 296,017          | 297,103             |
| Home equity loans                            | 52,965           | 53,303              |
| Other consumer loans                         | 18,025           | 19,001              |
| Total consumer loans                         | 367,007          | 369,407             |
| Tax exempt loans                             | 15,111           | 15,244              |
| Net deferred loan costs and fees             | (518)            | (555)               |
| Total loans                                  | 817,226          | 815,004             |
| Allowance for loan losses                    | (8,055)          | (8,097)             |
| Total loans net of allowance for loan losses | \$809,171        | \$806,907           |

**Commercial Loans:** At March 31, 2013, total commercial loans amounted to \$435,626, compared with \$430,908 at December 31, 2012, representing an increase of \$4,718, or 1.1%.

Commercial loan growth has generally been challenged by a still-troubled economy, continuing economic uncertainty, diminished demand, and strong competition for quality loans. Bank management attributes the continued growth in

commercial loans to an effective business banking team, deep local market knowledge, sustained new business development efforts, and a local economy that has fared better than the nation as a whole.

**Consumer Loans:** At March 31, 2013, total consumer loans, which principally consisted of residential real estate mortgage loans, amounted to \$367,007, compared with \$369,407 at December 31, 2012, representing a decline of \$2,400, or 0.6%.

During the three months ended March 31, 2013, loans originated and closed by the Bank were

more than offset by accelerated loan re-financings and principal pay-downs from the existing residential real estate loan portfolio, as borrowers continued to take advantage of historically low interest rates.

**Tax Exempt Loans:** At March 31, 2013, tax exempt loans amounted to \$15,111, compared with \$15,244 at December 31, 2012, representing a decline of \$133, or 0.9%. Tax-exempt loans generally include loans to or guaranteed by local government municipalities, federal agencies, not-for-profit organizations, and other organizations that qualify for tax-exempt treatment. Government municipality loans typically have short maturities (e.g., tax anticipation notes). Government municipality loans are normally originated through a bid process among local financial institutions and are typically priced aggressively, thus generating relatively narrow net interest margins.

**Credit Risk:** Credit risk is managed through loan officer authorities, loan policies, and oversight from the Bank's Senior Credit Officer, the Bank's Senior Loan Officers Committee, the Directors' Loan Committee, and the Bank's Board of Directors. Management follows a policy of continually identifying, analyzing and grading credit risk inherent in the loan portfolio. An ongoing independent review, subsequent to management's review, of individual credits is performed by an independent loan review consulting firm, which reports to the Audit Committee of the Board of Directors.

As a result of management's ongoing review of the loan portfolio, loans are placed on non-accrual status, either due to the delinquent status of principal and/or interest, or a judgment by management that, although payments of principal and or interest are current, such action is prudent because collection in full of all outstanding principal and interest is in doubt. Loans are generally placed on non-accrual status when principal and or interest is 90 days overdue, or sooner if judged appropriate by management. Consumer loans are generally charged-off when principal and/or interest payments are 120 days overdue, or sooner if judged appropriate by management.

**Non-performing Loans:** Non-performing loans include loans on non-accrual status and loans past due 90 days or more and still accruing interest. The following table sets forth the details of non-performing loans as of the dates indicated:

**TOTAL NON-PERFORMING LOANS**

|   | <b>March 31,</b> | <b>December 31,</b> |
|---|------------------|---------------------|
|   | <b>2013</b>      | <b>2012</b>         |
| Commercial real estate mortgages                      | \$1,633          | \$1,888             |
| Commercial and industrial loans                       | 632              | 818                 |
| Commercial construction and land development          | 2,029            | 2,359               |
| Agricultural and other loans to farmers               | 562              | 664                 |
| Total commercial loans                                | 4,856            | 5,729               |
| Residential real estate mortgages                     | 2,841            | 3,017               |
| Home equity loans                                     | 767              | 814                 |
| Other consumer loans                                  | 81               | 72                  |
| Total consumer loans                                  | 3,689            | 3,903               |
| Total non-accrual loans                               | 8,545            | 9,632               |
| Accruing loans contractually past due 90 days or more | 47               | 235                 |
| Total non-performing loans                            | \$8,592          | \$9,867             |
| Allowance for loan losses to non-performing loans     | 93.8%            | 82.1%               |
| Non-performing loans to total loans                   | 1.05%            | 1.21%               |
| Allowance to total loans                              | 0.99%            | 0.99%               |

At March 31, 2013, total non-performing loans amounted to \$8,592, compared with \$9,867 at December 31, 2012, representing a decline of \$1,275, or 12.9%. As more fully discussed below, one commercial real estate loan to a local, non-profit affordable housing authority in support of an affordable housing project accounted for \$2,029, or 23.6% of total non-performing loans.

Non-performing commercial real estate mortgages totaled to \$1,633 at March 31, 2013, down from \$1,888 at December 31, 2012. At March 31, 2013, non-performing commercial real estate mortgages were represented by nine business relationships, with outstanding balances ranging from \$24 to \$311.

Non-performing commercial and industrial loans totaled \$632 at March 31, 2013, down from \$818 at December 31, 2012. At March 31, 2013, non-performing commercial and industrial loans were represented by eight business relationships, with outstanding balances ranging from \$20 to \$164.

Non-performing commercial construction and land development loans totaled \$2,029 at March 31, 2013, down from \$2,359 at December 31, 2012. At March 31, 2013, non-performing commercial construction and land development loans were entirely represented by a commercial real estate loan to a local, non-profit affordable housing authority in support of an affordable housing project. This loan is principally secured by the housing units from the project. The project is fully constructed and there is no construction risk associated with the loan. The primary source of repayment is the sale of the existing housing units. This loan is impaired and was put on non-accrual status in late 2010. To date, the Bank has charged off \$2,014 of the original outstanding balance of this collateral dependent impaired loan. These charge-offs were based on current appraisals and revised prospects for future cash flows. This loan is recorded at fair value in the Company's financial statements.

Non-performing residential real estate mortgages totaled \$2,841 at March 31, 2013, down from \$3,017 at December 31, 2012. At March 31, 2013, non-performing residential real estate loans were represented by thirty-one, conventional, 1-4 family mortgage loans, with outstanding balances ranging from \$2 to \$409.

Non-performing home equity loans totaled \$767 at March 31, 2013, down from \$814 at December 31, 2012. At March 31, 2013, non-performing home equity loans were represented by nine relationships with outstanding balances ranging from \$0 to \$389.

While the level and mix of non-performing loans continued to reflect favorably on the overall quality of the Bank's loan portfolio at March 31, 2013, Bank management is cognizant of the weakened real estate market, elevated unemployment rates and soft economic conditions overall. Bank management believes that the current credit cycle has yet to reach a definitive turning point and it may be some time before the overall level of credit quality in the Bank's loan portfolio shows lasting improvement. Future levels of non-performing loans may be influenced by economic conditions, including the impact of those conditions on the Bank's customers, including debt service levels, declining collateral values, tourism activity, consumer confidence and other factors existing at the time. Management believes the economic activity and conditions in the local real estate markets will continue to be significant determinants of the quality of the loan portfolio in future periods and, thus, the Company's results of operations and financial condition.



***Delinquencies and Potential Problem Loans:*** In addition to the non-performing loans discussed above, the Bank also has loans that are 30 to 89 days delinquent and still accruing. These loans amounted to \$6,902 and \$3,529 at March 31, 2013 and December 31, 2012, or 0.84% and 0.43% of total loans, respectively, net of any loans classified as non-performing that are within these delinquency categories. These loans and delinquency trends in general are considered in the evaluation of the allowance for loan losses and the related determination of the provision for loan losses.

Periodically, the Bank reviews the commercial loan portfolio for evidence of potential problem loans. Potential problem loans are loans that are currently performing in accordance with contractual terms, but where known information about possible credit problems of the borrower causes doubt about the ability of the borrower to comply with the loan payment terms and may result in disclosure of such loans as non-performing at some time in the future.

At March 31, 2013, the Bank identified twenty-seven commercial relationships totaling \$9,884 as potential problem loans, or 1.21% of total loans. At December 31, 2012, the Bank identified thirty-three commercial relationships totaling \$10,297 as potential problem loans, or 1.26% of total loans. Factors such as payment history, value of supporting collateral, and personal or government guarantees led the Bank to conclude that the current risk exposure on these potential problem loans did not warrant accounting for the loans as non-performing. Although in a performing status as of quarter-end, these loans exhibited certain risk factors, which have the potential to cause them to become non-performing at some point in the future.

***Troubled Debt Restructures:*** A Troubled Debt Restructure ( TDR ) results from a modification to a loan to a borrower who is experiencing financial difficulty in which the Bank grants a concession to the debtor that it would not otherwise consider but for the debtor's financial difficulties. Financial difficulty arises when a debtor is bankrupt or contractually past due, or is likely to become so, based upon its ability to pay. A concession represents an accommodation not generally available to other customers, which may include below-market interest rate, deferment of principal payments, extension of maturity dates, etc. Such accommodations extended to customers who are not experiencing financial difficulty do not result in TDR classification.

As of March 31, 2013, the Bank had six real estate secured loans, three commercial and industrial loan, and one consumer loan, to five relationships totaling \$1,148 that were classified as TDRs. At March 31, 2013, five of these TDRs totaling \$1,016 were past due and classified as non-accrual.

As of December 31, 2012, the Bank had four real estate secured and three commercial and industrial loans to four relationships totaling \$934 that were classified as TDRs, of which three TDRs totaling \$114 were past due or classified as non-performing

**Allowance for Loan Losses:** At March 31, 2013, the allowance for loan losses (the allowance ) stood at \$8,055, compared with \$8,097 at December 31, 2012, representing a decline of \$42, or 0.5%. The small decline in the allowance from December 31, 2012 largely reflected an overall improvement in the Bank's credit quality metrics, combined with relatively flat loan growth during the quarter.

At March 31, 2013, the allowance expressed as a percentage of total loans stood at 0.99%, unchanged compared with December 31, 2012. As of March 31, 2013, total non-performing loans to total loans stood at 1.05%, down from 1.21% at December 31, 2012. At March 31, 2013, the allowance expressed as a percentage of non-performing loans stood at 93.8%, up from 82.1% at December 31, 2012.

The allowance is available to absorb probable losses on loans. The determination of the adequacy of the allowance and provisioning for estimated losses is evaluated quarterly based on review of loans, with particular emphasis on non-performing and other loans that management believes warrant special consideration.

The allowance is maintained at a level that, in management's judgment, is appropriate for the amount of risk inherent in the current loan portfolio, and adequate to provide for estimated, probable losses. Allowances are established for specific impaired loans, a pool of reserves based on historical net loan charge-offs by loan types, and supplemental reserves that adjust historical net loss experience to reflect current economic conditions, industry specific risks, and other qualitative and environmental considerations impacting the inherent risk of loss in the current loan portfolio.

Specific allowances for impaired loans are determined based upon a discounted cash flows analysis, or as appropriate, a collateral shortfall analysis. The amount of collateral dependent impaired loans totaled \$2,826 as of March 31, 2013, compared with \$3,149 as of December 31, 2012. The related allowances for loan losses on these loans amounted to \$120 as of March 31, 2013, compared with \$120 as of December 31, 2012.

Management recognizes that early and accurate recognition of risk is the best means to reduce credit losses. The Bank employs a comprehensive risk management structure to identify and manage the risk of loss. For consumer loans, the Bank identifies loan delinquency beginning at 10-day delinquency and provides appropriate follow-up by written correspondence or personal contact. Non-residential mortgage consumer loan losses are recognized no later than the point at which a loan is 120 days past due. Residential mortgage losses are recognized during the foreclosure process, or sooner, when that loss is quantifiable and reasonably assured. For commercial loans, the Bank applies a risk grading system, which stratifies the portfolio and allows management to focus appropriate efforts on the highest risk components of the portfolio. The risk grades include ratings that correlate substantially with regulatory definitions of Pass, Other Assets Especially Mentioned, Substandard, Doubtful, and Loss.

While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers may necessitate future additions or reductions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance, which also may necessitate future additions or reductions to the allowance, based on information available to them at the time of their examination.

The following table details changes in the allowance and summarizes loan loss experience by loan type for the three-month periods ended March 31, 2013, and 2012.

**ALLOWANCE FOR LOAN LOSSES****THREE MONTHS ENDED****MARCH 31, 2013 AND 2012**

|  | <b>2013</b> | <b>2012</b> |
|--|-------------|-------------|
| Balance at beginning of period               | \$ 8,097    | \$8,221     |
| <b>Charge offs:</b>                          |             |             |
| Commercial real estate mortgages             | ---         | \$ 25       |
| Commercial and industrial                    | 164         | 17          |
| Commercial construction and land development | ---         | ---         |
| Agricultural and other loans to farmers      | ---         | 10          |
| Residential real estate mortgages            | 228         | 182         |
| Other consumer loans                         | 28          | 119         |
| Home equity loans                            | 9           | ---         |
| Tax exempt loans                             | ---         | ---         |
| <b>Total charge-offs</b>                     | <b>429</b>  | <b>353</b>  |
| <b>Recoveries:</b>                           |             |             |
| Commercial real estate mortgages             | ---         | \$ 1        |
| Commercial and industrial loans              | 10          | 6           |
| Commercial construction and land development | ---         | ---         |
| Agricultural and other loans to farmers      | 1           | 25          |
| Residential real estate mortgages            | ---         | ---         |
| Other consumer loans                         | 5           | 6           |
| Home equity loans                            | 18          | ---         |
| Tax exempt loans                             | ---         | ---         |
| <b>Total recoveries</b>                      | <b>34</b>   | <b>38</b>   |
| <b>Net charge-offs</b>                       | <b>395</b>  | <b>315</b>  |
| Provision charged to operations              | 353         | 415         |
| Balance at end of period                     | \$8,055     | \$8,321     |

For the three months ended March 31, 2013, total net loan charge-offs amounted to \$395, or annualized net charge-offs to average loans outstanding of 0.19%, compared with \$315, or annualized net charge-offs to average loans outstanding of 0.17%, in the first quarter of 2012.

General allowances for loan losses account for the risk and estimated loss inherent in certain pools of industry and geographic loan concentrations within the loan portfolio. There were no material changes in loan concentrations during the three months ended March 31, 2013.

Based upon the process employed and giving recognition to all attendant factors associated with the loan portfolio, Company management believes the allowance for loan losses at March 31, 2013, is appropriate for the amount of risk inherent in the current loan portfolio and adequate to provide for estimated probable losses.

Further information regarding loans and the allowance for loan losses, is incorporated by reference to above Notes 6, Loans and Allowance for Loan Losses, of the interim unaudited consolidated financial statements in Part I, Item 1 of this report on Form 10-Q.

**Other Real Estate Owned:** Real estate acquired in satisfaction of a loan is reported in other assets. Properties acquired by foreclosure or deed in lieu of foreclosure are transferred to other real estate owned ( OREO ) and recorded at the lower of cost or fair market value less estimated costs to sell based on appraised value at the date actually or constructively received. Loan losses arising from the acquisition of such property are charged against the allowance for loan losses. Subsequent reductions in fair value below the carrying value are charged to other operating expenses.

At March 31, 2013, the Bank's OREO amounted to \$2,805, compared with \$2,780 as of December 31, 2012. Nine residential and seven commercial properties comprised the March 31, 2013 balance of OREO.

## Deposits

Historically, the banking business in the Bank's market area has been seasonal, with lower deposits in the winter and spring and higher deposits in summer and autumn. These seasonal swings have been fairly predictable and have not had a materially adverse impact on the Bank. Seasonal swings in deposits have been typically absorbed by the Bank's strong liquidity position, including borrowing capacity from the FHLB of Boston, brokered certificates of deposit obtained from the national market and cash flows from the securities portfolio.

At March 31, 2013, total deposits stood at \$801,100, compared with \$795,765 at December 31, 2012, representing an increase of \$5,335, or 0.7%. Demand, NOW, and savings and money market accounts experienced a combined seasonal decline of \$24,022, or 5.6%, compared with December 31, 2012, while time deposits were up \$29,357, or 7.9%. The increase in time deposits was largely attributed to brokered deposits obtained from the national market, which were utilized to replace seasonal deposit outflows while preserving the Company's strong, on-balance sheet liquidity position.

## Borrowed Funds

Borrowed funds principally consist of advances from the FHLB of Boston (the FHLB ) and, to a lesser extent, securities sold under agreements to repurchase, Fed funds purchased and borrowings from the Federal Reserve Bank of Boston. Advances from the FHLB are secured by stock in the FHLB, investment securities, blanket liens on qualifying mortgage loans and home equity loans, and certain commercial real estate loans. Borrowings from the Federal Reserve Bank of Boston are principally secured by municipal securities and liens on certain commercial real-estate loans.

The Bank utilizes borrowed funds to leverage its strong capital position and support its earning asset portfolios. Borrowed funds are principally utilized to support the Bank's investment securities portfolio and, to a lesser extent, fund loan growth. Borrowed funds also provide a means to help manage balance sheet interest rate risk, given the Bank's ability to select desired amounts, terms and maturities on a daily basis.

At March 31, 2013, total borrowings amounted to \$371,663, compared with \$371,567 at December 31, 2012, representing an increase of \$96, or 0.03%.

## Capital Resources

Consistent with its long-term goal of operating a sound and profitable organization, at March 31, 2013, the Company maintained its strong capital position and continued to be a well-capitalized financial institution according to applicable regulatory standards. Management believes this to be vital in promoting depositor and investor confidence and providing a solid foundation for future growth.

**Capital Ratios:** The Company and the Bank are subject to the risk-based capital guidelines administered by the Company's and the Bank's principal regulators. The risk-based capital guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Under these guidelines, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of risk-weighted assets and off-balance sheet items. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to risk-weighted assets of 8%, including a minimum ratio of Tier I capital to total risk-weighted assets of 4% and a Tier I capital to average assets of 4% (Leverage Ratio). Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary actions by regulators that, if undertaken, could have a material adverse effect on the Company's financial statements.

As of March 31, 2013, the Company and the Bank were considered *well-capitalized* under the regulatory framework for prompt corrective action. Under the capital adequacy guidelines, a *well-capitalized* institution must maintain a minimum total risk-based capital to total risk-weighted assets ratio of at least 10.0%, a minimum Tier I capital to total risk-weighted assets ratio of at least 6.0%, and a minimum Tier I Leverage ratio of at least 5.0%. At March 31, 2013, the Company's Total Risk-based, Tier I Risk-based, and Tier I Leverage ratios were 16.20%, 14.56% and 9.04%, respectively.

The following tables set forth the Company's and the Bank's regulatory capital at March 31, 2013, and December 31, 2012, under the rules applicable at that date.

|                     | <b>For Capital</b>       | <b>Capitalized under</b> |
|---------------------|--------------------------|--------------------------|
| <b>Consolidated</b> | <b>Adequacy Purposes</b> | <b>Prompt corrective</b> |
|                     |                          | <b>Action provisions</b> |

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|   | Actual    |        | Required |       | Required |       |
|---|-----------|--------|----------|-------|----------|-------|
|   | Amount    | Ratio  | Amount   | Ratio | Amount   | Ratio |
| <b>March 31, 2013</b>                       |           |        |          |       |          |       |
| Total Capital<br>(To Risk-Weighted Assets)  |           |        |          |       |          |       |
| Consolidated                                | \$130,150 | 16.20% | \$64,270 | 8.0%  | N/A      |       |
| Bank  | \$130,805 | 16.30% | \$64,209 | 8.0%  | \$80,261 | 10.0% |
| Tier 1 Capital<br>(To Risk-Weighted Assets) |           |        |          |       |          |       |
| Consolidated                                | \$116,972 | 14.56% | \$32,135 | 4.0%  | N/A      |       |
| Bank  | \$117,627 | 14.66% | \$32,105 | 4.0%  | \$48,157 | 6.0%  |
| Tier 1 Capital<br>(To Average Assets)       |           |        |          |       |          |       |
| Consolidated                                | \$116,972 | 9.04%  | \$51,765 | 4.0%  | N/A      |       |
| Bank  | \$117,627 | 9.09%  | \$51,735 | 4.0%  | \$64,669 | 5.0%  |

|   | To be well             |        |                               |       |                               |       |
|---|------------------------|--------|-------------------------------|-------|-------------------------------|-------|
|   | Capitalized under      |        |                               |       |                               |       |
|   | For Capital            |        |                               |       | Prompt corrective             |       |
|   | Consolidated<br>Actual |        | Adequacy Purposes<br>Required |       | Action provisions<br>Required |       |
|   | Amount                 | Ratio  | Amount                        | Ratio | Amount                        | Ratio |
| <b>December 31, 2012</b>                    |                        |        |                               |       |                               |       |
| Total Capital<br>(To Risk-Weighted Assets)  |                        |        |                               |       |                               |       |
| Consolidated                                | \$127,857              | 15.78% | \$64,812                      | 8.0%  | N/A                           |       |
| Bank  | \$128,791              | 15.92% | \$64,718                      | 8.0%  | \$80,897                      | 10.0% |
| Tier 1 Capital<br>(To Risk-Weighted Assets) |                        |        |                               |       |                               |       |
| Consolidated                                | \$114,667              | 14.15% | \$32,406                      | 4.0%  | N/A                           |       |
| Bank  | \$115,601              | 14.29% | \$32,359                      | 4.0%  | \$48,538                      | 6.0%  |
| Tier 1 Capital<br>(To Average Assets)       |                        |        |                               |       |                               |       |
| Consolidated                                | \$114,667              | 8.87%  | \$51,730                      | 4.0%  | N/A                           |       |
| Bank  | \$115,601              | 8.94%  | \$51,701                      | 4.0%  | \$64,626                      | 5.0%  |

**Trends, Events or Uncertainties:** There are no known trends, events or uncertainties, nor any recommendations by any regulatory authority, that are reasonably likely to have a material effect on the Company's capital resources, liquidity, or financial condition.

**Cash Dividends:** The Company's principal source of funds to pay cash dividends and support its commitments is derived from Bank operations.

The Company paid a regular cash dividend of \$0.305 per share of common stock in the first quarter of 2013, representing an increase of \$0.02 or 7.0% compared with the dividend paid for the same quarter in 2012. The Company's Board of Directors recently declared a second quarter 2013 regular cash dividend of \$0.31 per share of common stock, representing an increase of \$0.02, or 6.9% compared with the second of 2012.

**Stock Repurchase Plan:** In August 2008, the Company's Board of Directors approved a program to repurchase up to 300,000 shares of the Company's common stock, or approximately 10.2% of the shares then currently outstanding. The new stock repurchase program became effective as of August 21, 2008, and was authorized to continue for a period of up to twenty-four consecutive months. In August of 2010, the Company's Board of Directors authorized the continuance of this program through August 17, 2012. In August of 2012, the Company's Board of Directors authorized the continuance of this program through August 17, 2014. Depending on market conditions and other

factors, these purchases may be commenced or suspended at any time, or from time to time, without prior notice and may be made in the open market or through privately negotiated transactions.

As of March 31, 2013, the Company had repurchased 104,252 shares of stock under this plan, at a total cost of \$2,912 and an average price of \$27.94 per share. During the three months ended March 31, 2013, no shares were repurchased under the plan. The Company records repurchased shares as treasury stock.

#### **Off-Balance Sheet Arrangements**

The Company is, from time to time, a party to certain off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, that may be considered material to investors.

**Standby Letters of Credit:** The Bank guarantees the obligations or performance of certain customers by issuing standby letters of credit to third parties. These letters of credit are sometimes issued in support of third party debt. The risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same origination, portfolio maintenance and management procedures in effect to monitor other credit products. The amount of collateral obtained, if deemed necessary by the Bank upon issuance of a standby letter of credit, is based upon management's credit evaluation of the customer.

At March 31, 2013, commitments under existing standby letters of credit totaled \$245, compared with \$307 at December 31, 2012. The fair value of the standby letters of credit was not significant as of the foregoing dates.

**Commitments to Extend Credit:** Commitments to extend credit represent agreements by the Bank to lend to a customer provided there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee.

Since many of these commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis using the same credit policies as it does for its balance sheet instruments. The amount of collateral obtained, if deemed necessary by the Bank upon the issuance of commitment, is based on management's credit evaluation of the customer.

The following table details the notional or contractual amount for financial instruments with off-balance sheet risk as of March 31, 2013, and December 31, 2012:

|  | <b>March 31,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|--|---------------------------|------------------------------|
| Commitments to originate loans             | \$ 30,376                 | \$ 20,843                    |
| Unused lines of credit                     | 102,106                   | 106,773                      |
| Commitment to purchase loans               | 20,000                    | ---                          |
| Un-advanced portions of construction loans | 24,497                    | 22,047                       |
| Total                                      | \$176,979                 | \$149,663                    |

## Liquidity

Liquidity is measured by the Company's ability to meet short-term cash needs at a reasonable cost or minimal loss. The Company seeks to obtain favorable sources of liabilities and to maintain prudent levels of liquid assets in order to satisfy varied liquidity demands. Besides serving as a funding source for maturing obligations, liquidity provides flexibility in responding to customer-initiated needs. Many factors affect the Company's ability to meet liquidity needs,

including variations in the markets served by its network of offices, its mix of assets and liabilities, reputation and credit standing in the marketplace, and general economic conditions.

The Bank actively manages its liquidity position through target ratios established under its asset liability management policy. Continual monitoring of these ratios, both historical and through forecasts under multiple rate scenarios, allows the Bank to employ strategies necessary to maintain adequate liquidity. A portion of the Bank's deposit base has been historically seasonal in nature, with balances typically declining in the winter months through late spring, during which period the Bank's liquidity position tightens.

The Bank uses a basic surplus model to measure its liquidity over 30 and 90-day time horizons. The relationship between liquid assets and short-term liabilities that are vulnerable to non-replacement are routinely monitored. The Bank's general policy is to maintain a liquidity position of at least 4.0% of total assets over the 30 day horizon. At March 31, 2013, liquidity, as measured by the basic surplus/deficit model, was 6.2% over the 30-day horizon and 5.6% over the 90-day horizon, in part reflecting the impact of seasonal deposit outflows.

At March 31, 2013, the Bank had unused lines of credit and net unencumbered qualifying collateral availability to support its credit line with the FHLB of Boston approximating \$124 million. The Bank also had capacity to borrow funds on a secured basis utilizing the Borrower-In-Custody ( BIC ) program and the Discount Window at the Federal Reserve Bank of Boston. At March 31, 2013, the Bank's available secured line of credit at the Federal Reserve Bank of Boston stood at \$190,782, or 14.6% of the Bank's total assets. The Bank also has access to the national brokered deposit market, and periodically uses this funding source to bolster its on-balance sheet liquidity position.

The Bank maintains a liquidity contingency plan approved by the Bank's Board of Directors. This plan addresses the steps that would be taken in the event of a liquidity crisis, and identifies other sources of liquidity available to the Company. The Company believes that the level of liquidity is sufficient to meet current and future funding requirements. However, changes in economic conditions, including consumer savings habits and availability or access to the brokered deposit market could potentially have a significant impact on the Company's liquidity position.

### **Recent Accounting Developments**

The following information presents a summary of Accounting Standards Updates ( ASU s ) that were recently adopted by the Company, as well as those that will be subject to implementation in future periods.

ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 amends Topic 210, *Balance Sheet*, to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on January 1, 2013, and did not have a material impact on the Company's consolidated financial statements.

ASU 2012-02, Intangibles Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment. Under the guidance in this ASU, an entity has the option to bypass the qualitative assessment outlined in ASU 2011-08, Intangibles Goodwill and Other (Topic 350): Testing Goodwill for Impairment, for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. The amendments in this ASU are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity's financial statements for the most recent annual or interim period have not yet been issued or, for non-public entities, have not yet been made available for issuance. The adoption of this ASU did not have a significant impact to the Company's financial statements.

ASU 2012-03, Technical Amendments and Corrections to SEC Sections Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 114, Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update 2010-22. The amendments in ASU 2012-03 that have no transition guidance are effective immediately for public and private entities. Amendments that are subject to transition guidance will be effective for public companies for fiscal periods beginning after December 15, 2012, and for nonpublic entities for fiscal periods beginning after December 15, 2013. The adoption of this ASU did not have a significant impact to the Company's financial statements.

ASU 2013-02, Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of this update is to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments in this update apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP and that report items of other comprehensive income. Public companies are required to comply with these amendments for all reporting periods presented, including interim periods. For public entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2012. Adoption of this update did not have a material impact on our financial condition or results of operations.

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates/prices, such as interest rates, foreign currency exchange rates, commodity prices and equity prices. Interest rate risk is the most significant market risk affecting the Company. Other types of market risk do not arise in the normal course of the Company's business activities.

**Interest Rate Risk:** Interest rate risk can be defined as an exposure to movement in interest rates that could have an adverse impact on the Bank's net interest income. Interest rate risk arises from the imbalance in the re-pricing, maturity and/or cash flow characteristics of assets and liabilities. Management's objectives are to measure, monitor and develop strategies in response to the interest rate risk profile inherent in the Bank's balance sheet. The objectives in managing the Bank's balance sheet are to preserve the sensitivity of net interest income to actual or potential changes in interest rates, and to enhance profitability through strategies that promote sufficient reward for understood and controlled risk.

The Bank's interest rate risk measurement and management techniques incorporate the re-pricing and cash flow attributes of balance sheet and off balance sheet instruments as they relate to current and potential changes in interest rates. The level of interest rate risk, measured in terms of the potential future effect on net interest income, is determined through the use of modeling and other techniques under multiple interest rate scenarios. Interest rate risk is evaluated in depth on a quarterly basis and reviewed by the Asset/Liability Committee ("ALCO") and the Bank's Board of Directors.

The Bank's Asset Liability Management Policy, approved annually by the Bank's Board of Directors, establishes interest rate risk limits in terms of variability of net interest income under rising, flat, and decreasing rate scenarios. It is the role of ALCO to evaluate the overall risk profile and to determine actions to maintain and achieve a posture consistent with policy guidelines.

The Bank utilizes an interest rate risk model widely recognized in the financial industry to monitor and measure interest rate risk. The model simulates the behavior of interest income and expense of all balance sheet and off-balance sheet instruments, under different interest rate scenarios together with a dynamic future balance sheet. Interest rate risk is measured in terms of potential changes in net interest income based upon shifts in the yield curve.

The interest rate risk sensitivity model requires that assets and liabilities be broken down into components as to fixed, variable, and adjustable interest rates, as well as other homogeneous groupings, which are segregated as to maturity and type of instrument. The model includes assumptions about how the balance sheet is likely to evolve through time and in different interest rate environments. The model uses contractual re-pricing dates for variable products, contractual maturities for fixed rate products, and product specific assumptions for deposit accounts, such as money market accounts, that are subject to re-pricing based on current market conditions. Re-pricing margins are also determined for adjustable rate assets and incorporated in the model. Investment securities and borrowings with call provisions are examined on an individual basis in each rate environment to estimate the likelihood of a call. Prepayment assumptions for mortgage loans and mortgage backed securities are developed from industry median

estimates of prepayment speeds, based upon similar coupon ranges and seasoning. Cash flows and maturities are then determined, and for certain assets, prepayment assumptions are estimated under different interest rate scenarios. Interest income and interest expense are then simulated under several hypothetical interest rate conditions including:

.  
A flat interest rate scenario in which current prevailing rates are locked in and the only balance sheet fluctuations that occur are due to cash flows, maturities, new volumes, and re-pricing volumes consistent with this flat rate assumption.

.  
A 200 basis point rise or decline in interest rates applied against a parallel shift in the yield curve over a twelve-month period together with a dynamic balance sheet anticipated to be consistent with such interest rate changes.

.  
Various non-parallel shifts in the yield curve, including changes in either short-term or long-term rates over a twelve-month horizon, together with a dynamic balance sheet anticipated to be consistent with such interest rate changes.

.  
An extension of the foregoing simulations to each of two, three, four and five year horizons to determine the interest rate risk with the level of interest rates stabilizing in years two through five. Even though rates remain stable during this two to five year time period, re-pricing opportunities driven by maturities, cash flow, and adjustable rate products will continue to change the balance sheet profile for each of the rate conditions.

Changes in net interest income based upon the foregoing simulations are measured against the flat interest rate scenario and actions are taken to maintain the balance sheet interest rate risk within established policy guidelines.

The following table summarizes the Bank's net interest income sensitivity analysis as of March 31, 2013, over one and two-year horizons and under rising and declining interest rate scenarios. In light of the Federal Funds rate of 0% to 0.25% and the two-year U.S. Treasury note of 0.26% on the date presented, the analysis incorporates a declining interest rate scenario of 100 basis points, rather than the 200 basis points, as would traditionally be the case.

## **INTEREST RATE RISK**

### **CHANGE IN NET INTEREST INCOME FROM THE FLAT RATE SCENARIO**

**MARCH 31, 2013**

| <b>-100 Basis Points</b> | <b>+200 Basis</b>      |
|--------------------------|------------------------|
| <b>Parallel Yield</b>    | <b>Points Parallel</b> |

|                          | <b>Curve Shift</b> | <b>Yield Curve Shift</b> |
|--------------------------|--------------------|--------------------------|
| <b>Year 1</b>            |                    |                          |
| Net interest income (\$) | \$ (559)           | \$142                    |
| Net interest income (%)  | -1.44%             | 0.37%                    |
| <b>Year 2</b>            |                    |                          |
| Net interest income (\$) | \$(1,124)          | \$807                    |
| Net interest income (%)  | -2.90%             | 2.08%                    |

As more fully discussed below, the March 31, 2013, interest rate sensitivity modeling results indicate that the Bank's balance sheet was about evenly matched over the one and two-year horizons.

Assuming interest rates remain at or near their current levels and the Bank's balance sheet structure and size remain at current levels, the interest rate sensitivity simulation model suggests that net interest income will remain relatively stable over the one and two-year horizons. The relatively stable trend over the one and two-year horizons principally results from funding costs rolling over at lower prevailing rates, while largely offsetting expected declines in earning asset yields.

Assuming short-term and long-term interest rates decline 100 basis points from current levels (i.e., a parallel yield curve shift) and the Bank's balance sheet structure and size remain at current levels, management believes net interest income will decline moderately over the one and two-year horizons as declining earning assets yields outpace reductions in funding costs. Should the yield curve steepen as rates fall, the model suggests that accelerated earning asset prepayments will slow, resulting in a more stabilized level of net interest income. Management anticipates that moderate to strong earning asset growth will be needed to meaningfully increase the Bank's current level of net interest income should both long-term and short-term interest rates decline in parallel.

Assuming the Bank's balance sheet structure and size remain at current levels and the Federal Reserve increases short-term interest rates by 200 basis points with the balance of the yield curve shifting in parallel with these increases, management believes net interest income will increase moderately over the one-year horizon and then trend steadily upward over the two-year horizon and beyond. The interest rate sensitivity simulation model suggests that as interest rates rise, the Bank's funding costs will initially re-price proportionately with earning asset yields. As funding costs begin to stabilize late in the first year of the simulation, the model suggests that the earning asset portfolios will continue to re-price at prevailing interest rate levels and cash flows from the Bank's earning asset portfolios will be reinvested into higher yielding earning assets, resulting in a widening of spreads and increases in net interest income over the two year horizon and beyond. Management believes moderate to strong earning asset growth will be necessary to meaningfully increase the current level of net interest income over the one-year horizon should short-term and long-term interest rates rise in parallel. Over the two-year horizon and beyond, management believes moderate earning asset growth will be necessary to meaningfully increase the current level of net interest income.

Interest rates plummeted during 2008 and have remained historically low ever since, as the global economy slowed at unprecedented levels, unemployment levels soared, delinquencies on all types of loans increased along with decreased consumer confidence and dramatic declines in housing prices. Management believes the most significant ongoing factor affecting market risk exposure and the impact on net interest income continues to be the very slow recovery from the severe nationwide recession and the U.S. Government's extraordinary responses, including a variety of government stimulus programs and quantitative easing strategies. Recent actions by the Federal Reserve have posed a further threat to net interest income, given its determination to maintain interest rates at historically low levels for an extended period of time. Net interest income exposure is also significantly affected by the shape and level of the U.S. Government securities and interest rate swap yield curve, and changes in the size and composition of the Bank's loan, investment and deposit portfolios.

The preceding sensitivity analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions including: the nature and timing of interest rate levels and yield curve shape, prepayment speeds on loans and securities, deposit rates, pricing decisions on loans and deposits, reinvestment or replacement of asset and liability cash flows, and renegotiated loan terms with borrowers. While assumptions are developed based upon current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions including how customer preferences or competitor influences might change.

As market conditions vary from those assumed in the sensitivity analysis, actual results may also differ due to: prepayment and refinancing levels deviating from those assumed; the impact of interest rate change caps or floors on adjustable rate assets; the potential effect of changing debt service levels on customers with adjustable rate loans;

depositor early withdrawals and product preference changes; and other such variables. The sensitivity analysis also does not reflect additional actions that the Bank's ALCO and board of directors might take in responding to or anticipating changes in interest rates, and the anticipated impact on the Bank's net interest income.

#### **ITEM 4. CONTROLS AND PROCEDURES**

Company management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this quarterly report. Based on such evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and regulations and are operating in an effective manner.

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

#### **PART II. OTHER INFORMATION**

##### **Item 1: Legal Proceedings**

The Company and its subsidiaries are parties to certain ordinary routine litigation incidental to the normal conduct of their respective businesses, which in the opinion of management based upon currently available information will have no material effect on the Company's consolidated financial statements.

##### **Item 1A: Risk Factors**

There have been no material changes to the Risk Factors previously disclosed in Part I, Item 1A of the Company's Annual Report on Form 10-K for the year-ended December 31, 2012.

##### **Item 6: Exhibits**

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The exhibits required to be furnished as part of this Quarterly Report on Form 10-Q are listed in the Exhibit Index hereto and are incorporated herein by reference.

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.

**BAR HARBOR BANKSHARES**

(Registrant)

/s/Joseph M. Murphy

Date: May 9, 2013

Joseph M. Murphy  
President & Chief Executive Officer

/s/Gerald Shencavitz

Date: May 9, 2013

Gerald Shencavitz  
Executive Vice President, Chief Financial Officer  
& Principal Accounting Officer

**Exhibit Index**

- 3.1 Articles of Incorporation, as amended to date (incorporated herein by reference to Form 10-K, Part IV, Item 15, Exhibit 3.1, filed with the Commission on March 16, 2009).
- 3.2 Bylaws, as amended to date (incorporated herein by reference to Form 8-K, Exhibit 3, filed with the Commission on November 29, 2011).
- 4 Instruments Defining Rights of Security Holders
  - 4.1 Certificate of Designations, Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated herein by reference to Form 8-K, Exhibit 3.1, filed with the Commission on January 21, 2009).
  - 4.2 Form of Specimen Stock Certificate for Series A Preferred Stock (incorporated by reference to Form 8-K, Exhibit 4.1, filed with the Commission on January 21, 2009).
  - 4.3 Debt Securities Purchase Agreement (incorporated herein by reference to Form 10-K, Part IV, Item 15, Exhibit 4.5, filed with the commission on March 16, 2009).
  - 4.4 Form of Subordinated Debt Security of Bar Harbor Bank & Trust (incorporated herein by reference to Form 10-K, Part IV, Item 15, Exhibit 4.6, filed with the Commission on March 16, 2009).
- 10.1 2013 Annual Incentive Plan (incorporated herein by reference to Form 8-K/A, Item 5.02(e), First Amendment, filed with the Commission on April 26, 2013, and Form 8-K, Item 5.02(e), filed with the Commission on January 25, 2013).
- 10.2 2013 through 2015 Long Term Executive Incentive Plan (incorporated herein by reference to Form 8-K, Item 5.02(e) and Exhibit 10.1, filed with the Commission on April 26, 2013).
- 11.1 Statement re computation of per share earnings (data required by SFAS No. 128, Earnings Per Share, is provided in Note 4 to the consolidated financial statements in this report on Form 10-Q and incorporated herein by reference thereto).
- 31.1 Certification of the Chief Executive Officer under Rule 13a-14(a)/15d-14(a) (filed herewith)
- 31.2 Certification of the Chief Financial Officer under Rule 13a-14(a)/15d-14(a) (filed herewith)
- 32.1 Certification of Chief Executive Officer under 18 U.S.C. Section 1350 (furnished herewith)
- 32.2 Certification of Chief Financial Officer under 18 U.S.C. Section 1350 (furnished herewith)

101\*

Financial statements from the quarterly report on Form 10-Q of Bar Harbor Bankshares for the quarter March 31, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Shareholders Equity and Comprehensive

Income, (iv) the Consolidated Statements of Cash Flows and (v) Notes to Consolidated Financial Statements.

\*

Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.