

CHEMUNG FINANCIAL CORP

Form 10-Q

August 19, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON D.C. 20549

FORM 10-Q

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

For Quarterly period ended June 30, 2011

Or

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

Commission File No. 0-13888

CHEMUNG FINANCIAL CORPORATION  
(Exact name of registrant as specified in its charter)

New York  
(State or other jurisdiction of incorporation or organization)

16-1237038  
I.R.S. Employer Identification No.

One Chemung Canal Plaza, P.O. Box 1522, Elmira, NY  
(Address of principal executive offices)

14902  
(Zip Code)

(607) 737-3711 or (800) 836-3711  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES:  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 definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

|                         |                          |                           |                                     |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Non-accelerated filer     | <input type="checkbox"/>            |
| Accelerated filer       | <input type="checkbox"/> | Smaller reporting company | <input checked="" type="checkbox"/> |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

YES:  NO:

The number of shares of the registrant's common stock, \$.01 par value, outstanding on July 29, 2011 was 4,573,695.



CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES

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## PART I. FINANCIAL INFORMATION

## Item 1: Financial Statements

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
 CONSOLIDATED BALANCE SHEETS  
 (UNAUDITED)

|   | JUNE 30,<br>2011 | DECEMBER,<br>31, 2010 |
|---|------------------|-----------------------|
| <b>ASSETS</b>   |                  |                       |
| Cash and due from financial institutions  | \$ 27,787,395    | \$ 16,540,095         |
| Interest-bearing deposits in other financial institutions   | 56,156,424       | 44,079,682            |
| Total cash and cash equivalents   | 83,943,819       | 60,619,777            |
| Securities available for sale, at estimated fair value  | 284,133,730      | 223,544,961           |
| Securities held to maturity, estimated fair value of \$8,792,461<br>at June 30, 2011 and \$8,297,392 at December 31, 2010                             | 8,040,872        | 7,715,123             |
| Federal Home Loan Bank and Federal Reserve Bank Stock, at cost  | 4,723,750        | 3,328,900             |
| Loans, net of deferred origination fees and costs, and unearned income  | 788,720,027      | 613,684,369           |
| Allowance for loan losses   | (9,755,672)      | (9,498,131)           |
| Loans, net  | 778,964,355      | 604,186,238           |
| Loans held for sale   | 351,055          | 486,997               |
| Premises and equipment, net   | 24,344,587       | 24,192,593            |
| Goodwill  | 22,551,090       | 9,872,375             |
| Other intangible assets, net  | 6,766,541        | 4,655,900             |
| Bank owned life insurance   | 2,580,326        | 2,536,715             |
| Other assets  | 20,635,998       | 17,187,706            |
| Total assets  | \$ 1,237,036,123 | \$ 958,327,285        |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                  |                       |
| Deposits:   |                  |                       |
| Non-interest-bearing  | \$ 245,273,828   | \$ 197,322,036        |
| Interest-bearing  | 768,688,273      | 589,036,816           |
| Total deposits  | 1,013,962,101    | 786,358,852           |
| Securities sold under agreements to repurchase  | 42,218,485       | 44,774,615            |
| Federal Home Loan Bank term advances  | 44,096,181       | 20,000,000            |
| Accrued interest payable  | 927,459          | 784,351               |
| Dividends payable   | 1,141,977        | 881,203               |
| Other liabilities   | 8,130,029        | 8,119,701             |
| Total liabilities   | 1,110,476,232    | 860,918,722           |
| Shareholders' equity:   |                  |                       |
| Common stock, \$.01 par value per share, 10,000,000 shares authorized;<br>5,310,076 issued at June 30, 2011 and 4,300,134 issued at December 31, 2010 | 53,101           | 43,001                |
| Additional-paid-in capital  | 45,718,649       | 22,022,122            |
| Retained earnings   | 96,659,359       | 94,407,620            |

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|   |                  |                |
|---|------------------|----------------|
| Treasury stock, at cost (741,281 shares at June 30, 2011;<br>749,880 shares at December 31, 2010) | (18,929,935)     | (19,166,655)   |
| Accumulated other comprehensive income (loss)   | 3,058,717        | 102,475        |
| Total shareholders' equity  | 126,559,891      | 97,408,563     |
| Total liabilities and shareholders' equity  | \$ 1,237,036,123 | \$ 958,327,285 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(UNAUDITED)

|   | Six Months Ended |                  | Three Months Ended |                  |
|---|------------------|------------------|--------------------|------------------|
|   | June 30,<br>2011 | June 30,<br>2010 | June 30,<br>2011   | June 30,<br>2010 |
| <b>INTEREST AND DIVIDEND INCOME</b>                 |                  |                  |                    |                  |
| Loans, including fees                               | \$ 19,783,190    | \$ 17,670,421    | \$ 11,207,847      | \$ 8,845,646     |
| Taxable securities                                  | 2,843,016        | 3,412,987        | 1,594,432          | 1,709,419        |
| Tax exempt securities                               | 684,511          | 588,021          | 369,088            | 295,701          |
| Interest-bearing deposits                           | 101,816          | 82,275           | 62,088             | 34,527           |
| Total interest and dividend income                  | 23,412,533       | 21,753,704       | 13,233,455         | 10,885,293       |
| <b>INTEREST EXPENSE</b>                             |                  |                  |                    |                  |
| Deposits  | 2,187,770        | 3,116,766        | 1,160,405          | 1,452,046        |
| Borrowed funds                                      | 497,938          | 471,597          | 263,513            | 237,172          |
| Securities sold under agreements to repurchase      | 729,553          | 874,333          | 358,454            | 417,553          |
| Total interest expense                              | 3,415,261        | 4,462,696        | 1,782,372          | 2,106,771        |
| Net interest income                                 | 19,997,272       | 17,291,008       | 11,451,083         | 8,778,522        |
| Provision for loan losses                           | 250,000          | 750,000          | 125,000            | 375,000          |
| Net interest income after provision for loan losses | 19,747,272       | 16,541,008       | 11,326,083         | 8,403,522        |
| Other operating income:                             |                  |                  |                    |                  |
| Trust & investment services income                  | 3,384,160        | 4,073,209        | 1,768,469          | 1,984,942        |
| Service charges on deposit accounts                 | 2,049,909        | 2,321,862        | 1,066,831          | 1,128,384        |
| Net gain on securities transactions                 | 679,209          | 451,094          | 485,811            | 451,094          |
| Other-than-temporary loss on investment securities: |                  |                  |                    |                  |
| Total impairment losses                             | -                | (336,625)        | -                  | (76,100)         |
| Loss recognized in other comprehensive income       | -                | -                | -                  | -                |
| Net impairment loss recognized in earnings          | -                | (336,625)        | -                  | (76,100)         |
| Net gain on sales of loans held for sale            | 79,332           | 133,565          | 32,400             | 82,077           |
| Credit card merchant earnings                       | 105,063          | 99,170           | 54,619             | 51,294           |
| Gains on sales of other real estate owned           | 88,961           | 33,550           | 88,961             | 33,550           |
| Income from bank owned life insurance               | 43,611           | 43,138           | 22,024             | 21,801           |
| Other   | 2,661,305        | 1,840,795        | 1,224,942          | 988,107          |
| Total other operating income                        | 9,091,550        | 8,659,758        | 4,744,057          | 4,665,149        |
| Other operating expenses:                           |                  |                  |                    |                  |
| Salaries and wages                                  | 8,261,602        | 7,593,955        | 4,338,097          | 3,759,735        |
| Pension and other employee benefits                 | 2,124,770        | 2,018,554        | 1,081,663          | 984,287          |
| Net occupancy expenses                              | 2,432,515        | 2,206,501        | 1,258,473          | 1,084,739        |
| Furniture and equipment expenses                    | 1,062,530        | 975,768          | 565,083            | 513,169          |
| Data processing expense                             | 1,905,099        | 1,635,006        | 1,043,286          | 832,131          |
| Amortization of intangible assets                   | 465,192          | 370,168          | 288,689            | 181,051          |
| Losses on sales of other real estate owned          | 1,671            | 25,557           | -                  | 25,557           |
| Other real estate owned expenses                    | 48,491           | 192,840          | 21,268             | 109,934          |
| FDIC insurance                                      | 442,385          | 625,353          | 189,989            | 320,045          |
| Merger related expenses                             | 2,223,419        | -                | 1,187,347          | -                |
| Other   | 3,676,924        | 3,016,827        | 2,227,065          | 1,604,083        |

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|                                      |              |              |              |              |
|--------------------------------------|--------------|--------------|--------------|--------------|
| Total other operating expenses       | 22,644,598   | 18,660,529   | 12,200,960   | 9,414,731    |
| Income before income tax expense     | 6,194,224    | 6,540,237    | 3,869,180    | 3,653,940    |
| Income tax expense                   | 1,909,105    | 2,037,041    | 1,249,076    | 1,150,931    |
| Net income                           | \$ 4,285,119 | \$ 4,503,196 | \$ 2,620,104 | \$ 2,503,009 |
| Weighted average shares outstanding  | 4,127,969    | 3,605,614    | 4,631,504    | 3,604,780    |
| Basic and diluted earnings per share | \$ 1.04      | \$ 1.25      | \$ 0.57      | \$ 0.69      |

See accompanying notes to unaudited consolidated financial statements.



CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME  
(UNAUDITED)

|   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total         |
|---|-----------------|----------------------------------|----------------------|-------------------|---|---------------|
| Balances at January 1, 2010   | \$ 43,001       | \$ 22,806,829                    | \$ 87,826,331        | \$ (20,024,661)   | \$ (565,835)  | \$ 90,085,665 |
| Comprehensive Income:   |                 |                                  |                      |                   |   |               |
| Net income  | -               | -                                | 4,503,196            | -                 | -   | 4,503,196     |
| Change in unrealized gains(losses) on securities AFS, net   | -               | -                                | -                    | -                 | 1,806,092   | 1,806,092     |
| Change in funded status of Employers' Accounting for Defined Benefit Pension and Other Benefit Plans, net | -               | -                                | -                    | -                 | 216,496   | 216,496       |
| Total comprehensive income  | -               | -                                | -                    | -                 | -   | 6,525,784     |
| Restricted stock units for directors' deferred compensation plan  | -               | 55,782                           | -                    | -                 | -   | 55,782        |
| Cash dividends declared (\$ .50 per share)  | -               | -                                | (1,761,150)          | -                 | -   | (1,761,150)   |
| Distribution of 10,082 shares of treasury stock for director's compensation                               | -               | (44,677)                         | -                    | 258,906           | -   | 214,229       |
| Distribution of 2,750 shares of treasury stock for employee compensation                                  | -               | (15,537)                         | -                    | 70,537            | -   | 55,000        |
| Purchase of 15,480 shares of treasury stock   | -               | -                                | -                    | (323,885)         | -   | (323,885)     |
| Balances at June 30, 2010   | \$ 43,001       | \$ 22,802,397                    | \$ 90,568,377        | \$ (20,019,103)   | \$ 1,456,756  | \$ 94,851,425 |
| Balances at January 1, 2011   | \$ 43,001       | \$ 22,022,122                    | \$ 94,407,620        | \$ (19,166,655)   | \$ 102,475  | \$ 97,408,563 |
| Comprehensive Income:   |                 |                                  |                      |                   |   |               |
| Net income  | -               | -                                | 4,285,119            | -                 | -   | 4,285,119     |
| Change in unrealized gains (losses) on securities AFS, net  | -               | -                                | -                    | -                 | 2,766,538   | 2,766,538     |
| Change in funded status of Employers' Accounting for Defined Benefit Pension and Other                    | -               | -                                | -                    | -                 | 189,704   | 189,704       |

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|   |           |               |               |                 |              |                |
|---|-----------|---------------|---------------|-----------------|--------------|----------------|
| Benefit Plans, net  |           |               |               |                 |              |                |
| Total comprehensive income (loss)   | -         | -             | -             | -               | -            | 7,241,361      |
| Restricted stock awards   | -         | 12,660        | -             | -               | -            | 12,660         |
| Restricted stock units for directors' deferred compensation plan                      | -         | 42,924        | -             | -               | -            | 42,924         |
| Cash dividends declared (\$ .50 per share)  | -         | -             | (2,033,380)   | -               | -            | (2,033,380)    |
| Distribution of 10,378 shares of treasury stock for directors' compensation           | -         | (33,831)      | -             | 265,262         | -            | 231,431        |
| Distribution of 2,392 shares of treasury stock for employee compensation              | -         | (6,140)       | -             | 61,140          | -            | 55,000         |
| Distribution of 286 shares of treasury stock for director's deferred Compensation     | -         | (7,364)       | -             | 7,310           | -            | (54)           |
| Distribution of 3,387 shares of treasury stock for employee restricted stock warrants | -         | (35,260)      | -             | 86,550          | -            | 51,290         |
| Purchase of 7,844 shares of treasury stock  | -         | -             | -             | (183,542)       | -            | (183,542)      |
| Issuance of 1,009,942 shares related to FOFC Merger                                   | 10,100    | 23,723,538    | -             | -               | -            | 23,733,638     |
| Balances at June 30, 2011   | \$ 53,101 | \$ 45,718,649 | \$ 96,659,359 | \$ (18,929,935) | \$ 3,058,717 | \$ 126,559,891 |
| See accompanying notes to unaudited consolidated financial statements.                |           |               |               |                 |              |                |

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

|   | Six Months Ended<br>June 30, |              |
|---|------------------------------|--------------|
|   | 2011                         | 2010         |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                              |              |
| Net income  | \$ 4,285,119                 | \$ 4,503,196 |
| Adjustments to reconcile net income to net cash provided by operating activities:   |                              |              |
| Amortization of intangible assets   | 465,192                      | 370,168      |
| Provision for loan losses   | 250,000                      | 750,000      |
| Depreciation and amortization of fixed assets                                       | 1,450,227                    | 1,395,291    |
| Amortization of premiums on securities, net   | 557,177                      | 329,895      |
| Gains on sales of loans held for sale, net  | (79,332)                     | (133,565)    |
| Proceeds from sales of loans held for sale  | 3,480,239                    | 4,503,070    |
| Loans originated and held for sale  | (3,264,965)                  | (4,267,369)  |
| Net gain on sale of other real estate owned   | (87,290)                     | (7,993)      |
| Net gains on securities transactions  | (679,209)                    | (451,094)    |
| Net impairment loss recognized on investment securities                             | -                            | 336,625      |
| Decrease (increase) in other assets   | 3,654,987                    | (500,904)    |
| (Increase) decrease in prepaid FDIC assessment                                      | (323,836)                    | 561,758      |
| Decrease in accrued interest payable  | (160,511)                    | (167,114)    |
| Expense related to restricted stock units for directors' deferred compensation plan | 42,924                       | 55,782       |
| Expense related to employee stock compensation                                      | 55,000                       | 55,000       |
| Expense related to employee stock awards  | 12,660                       | -            |
| Decrease in other liabilities   | (2,255,146)                  | (2,276,730)  |
| Income from bank owned life insurance   | (43,611)                     | (43,138)     |
| Proceeds from sales of student loans  | -                            | 137,509      |
| Net cash provided by operating activities   | 7,359,625                    | 5,150,387    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                              |              |
| Proceeds from sales and calls of securities available for sale                      | 56,656,054                   | 30,440,459   |
| Proceeds from maturities and principal collected on securities available for sale   | 14,554,015                   | 40,300,934   |
| Proceeds from maturities and principal collected on securities held to maturity     | 2,579,275                    | 7,712,800    |
| Purchases of securities available for sale  | (80,994,140)                 | (99,052,056) |
| Purchases of securities held to maturity  | (2,905,024)                  | (4,865,041)  |
| Purchase of Federal Home Loan Bank and Federal Reserve Bank stock                   | (45,000)                     | (58,200)     |
| Redemption of Federal Home Loan Bank and Federal Reserve Bank stock                 | 228,450                      | -            |
| Purchases of premises and equipment   | (722,734)                    | (704,672)    |
| Cash paid Fort Orange Financial Corp. acquisition                                   | (8,137,816)                  | -            |
| Cash received Fort Orange Financial Corp. acquisition                               | 33,284,995                   | -            |
| Proceeds from sale of other real estate owned                                       | 323,143                      | 228,528      |
| Net (increase) decrease in loans  | (10,752,681)                 | 6,206,890    |
| Net cash provided (used) by investing activities                                    | 4,068,537                    | (19,790,358) |

**CASH FLOWS FROM FINANCING ACTIVITIES:**

|   |               |               |
|---|---------------|---------------|
| Net increase in demand deposits, NOW accounts, savings accounts,<br>and insured money market accounts | 29,819,077    | 39,673,352    |
| Net decrease in time deposits and individual retirement accounts                                      | (2,684,163)   | (8,299,471)   |
| Net decrease in securities sold under agreements to repurchase  | (13,124,903)  | (8,975,159)   |
| Net decrease in Federal Home Loan Bank long term advances   | (157,983)     | -             |
| Purchase of treasury stock  | (183,542)     | (323,885)     |
| Cash dividends paid   | (1,772,606)   | (1,761,812)   |
| Net cash provided by financing activities   | 11,895,880    | 20,313,025    |
| Net increase in cash and cash equivalents   | 23,324,042    | 5,673,054     |
| Cash and cash equivalents, beginning of period  | 60,619,777    | 79,738,396    |
| Cash and cash equivalents, end of period  | \$ 83,943,819 | \$ 85,411,450 |

See accompanying notes to unaudited consolidated financial statements.

(Cash Flow continued)

Supplemental disclosure of cash flow information:

Cash paid during the year for:

|              |              |              |
|--------------|--------------|--------------|
| Interest     | \$ 3,272,153 | \$ 4,629,810 |
| Income Taxes | \$ 2,204,866 | \$ 3,225,675 |

Supplemental disclosure of non-cash activity:

|  |           |            |
|--|-----------|------------|
| Transfer of loans to other real estate owned | \$ 32,621 | \$ 517,646 |
|--|-----------|------------|

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

Chemung Financial Corporation (the "Corporation"), through its wholly owned subsidiaries, Chemung Canal Trust Company (the "Bank") and CFS Group, Inc., a financial services company, provides a wide range of banking, financing, fiduciary and other financial services to its local market area. The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries. All material intercompany accounts and transactions are eliminated in consolidation.

The data in the consolidated balance sheet as of December 31, 2010 was derived from the audited consolidated financial statements in the Corporation's 2010 Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 16, 2011. That data, along with the other interim financial information presented in the consolidated balance sheets, statements of income, shareholders' equity and comprehensive income, and cash flows should be read in conjunction with the audited consolidated financial statements, including the notes thereto, contained in the 2010 Annual Report on Form 10-K. Amounts in prior periods' consolidated interim financial statements are reclassified whenever necessary to conform to the current period's presentation.

The consolidated financial statements included herein reflect all adjustments which are, in the opinion of management, of a normal recurring nature and necessary to present fairly the Corporation's financial position as of June 30, 2011 and December 31, 2010, and results of operations for the three and six-month periods ended June 30, 2011 and 2010, and changes in shareholders' equity and cash flows for the six-month periods ended June 30, 2011 and 2010. Subsequent events were evaluated for any required recognition or disclosure. The results for the periods presented are not necessarily indicative of results to be expected for the entire fiscal year or any other interim period.

2. Earnings Per Common Share

Basic earnings per share is net income divided by the weighted average number of common shares outstanding during the period. Issuable shares including those related to directors' restricted stock units and directors' stock compensation are considered outstanding and are included in the computation of basic earnings per share as they are earned. All outstanding unvested share based payment awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation. The restricted stock awards granted in December 2010 are grants of participating securities. The impact of the participating securities on earnings per share is not material. Earnings per share information is adjusted to present comparative results for stock splits and stock dividends that occur. Earnings per share were computed by dividing net income by 4,127,969 and 3,605,614 weighted average shares outstanding for the six-month periods ended June 30, 2011 and 2010, and 4,631,504 and 3,604,780 weighted average shares outstanding for the three-month periods ended June 30, 2011 and 2010, respectively. There were no dilutive common stock equivalents during the three and six-month periods ended June 30, 2011 or 2010.

3. Fair Value

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

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

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

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

The fair values of securities available for sale are usually determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs), or matrix pricing, which is a mathematical technique widely used to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The Corporation's investment in collateralized debt obligations consisting of pooled trust preferred securities which are issued by financial institutions were historically priced using Level 2 inputs. The lack of observable inputs and market activity in this class of investments has been significant and resulted in unreliable external pricing. Broker pricing and bid/ask spreads, when available, have varied widely. The once active market has become comparatively inactive. As a result, these investments are now priced using Level 3 inputs.

The Corporation has developed an internal model for pricing these securities. This is the same model used in determining other-than-temporary impairment ("OTTI") as further described in Note 8. Information such as historical and current performance of the underlying collateral, deferral/default rates, collateral coverage ratios, break in yield calculations, cash flow projections, liquidity and credit premiums required by a market participant, and financial trend analysis with respect to the individual issuing financial institutions, are utilized in determining individual security valuations. Discount rates were utilized along with the cash flow projections in order to calculate an appropriate fair value. These discount rates were calculated based on industry index rates and adjusted for various credit and liquidity factors. Due to current market conditions as well as the limited trading activity of these securities, the market value of the securities is highly sensitive to assumption changes and market volatility.

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals and collateral evaluations. The appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by third party appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Non-recurring adjustments to certain commercial and residential real estate properties classified as other real estate owned ("OREO") are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value less costs to sell, an impairment loss is recognized.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

|   | Fair Value     | Fair Value Measurement at June 30, 2011<br>Using                                 |   |  |
|---|----------------|--|---|--|
|   |                | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial Assets:   |                |  |   |  |
| Obligations of U.S. Government and U.S.<br>Government sponsored enterprises | \$ 138,564,924 | \$ 40,993,000  | \$ 97,571,924   | \$ -   |
| Mortgage-backed securities, residential                                     | 61,853,786     | -  | 61,853,786  | -  |
| Obligations of states and political subdivisions                            | 48,602,858     | -  | 48,602,858  | -  |
| Trust Preferred securities  | 2,395,329      | -  | 2,023,594   | 371,735  |
| Corporate bonds and notes   | 14,625,858     | -  | 14,625,858  | -  |
| CMO's   | 9,205,469      | -  | 9,205,469   | -  |
| SBA Pool's  | 2,370,423      | -  | 2,370,423   | -  |
| Corporate stocks  | 6,515,083      | 5,830,663  | 684,420   | -  |
| Total available for sale securities   | \$ 284,133,730 | \$ 46,823,663  | \$ 236,938,332  | \$ 371,735   |

|   | Fair Value     | Fair Value Measurement at December 31,<br>2010 Using                             |   |  |
|---|----------------|--|---|--|
|   |                | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial Assets:   |                |  |   |  |
| Obligations of U.S. Government and U.S.<br>Government sponsored enterprises | \$ 102,131,517 | \$ 40,581,250  | \$ 61,550,267   | \$ -   |
| Mortgage-backed securities, residential                                     | 62,761,633     | -  | 62,761,633  | -  |
| Obligations of states and political subdivisions                            | 38,765,092     | -  | 38,765,092  | -  |
| Trust Preferred securities  | 2,344,094      | -  | 2,009,509   | 334,585  |
| Corporate bonds and notes   | 11,694,190     | -  | 11,694,190  | -  |
| Corporate stocks  | 5,848,435      | 5,209,069  | 639,366   | -  |
| Total available for sale securities   | \$ 223,544,961 | \$ 45,790,319  | \$ 177,420,057  | \$ 334,585   |



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The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six-month periods ending June 30, 2011 and 2010:

|  | Fair Value<br>Measurement<br>six-months<br>ended June<br>30, 2011<br>Using<br>Significant<br>Unobservable<br>Inputs (Level<br>3) | Fair Value<br>Measurement<br>six-months<br>ended June<br>30, 2010<br>Using<br>Significant<br>Unobservable<br>Inputs (Level<br>3) |
|--|--|--|
| Investment Securities Available for Sale   |  |  |
| Beginning balance                          | \$ 334,585   | \$ 511,480   |
| Total gains/losses (realized/unrealized):  |  |  |
| Included in earnings:                      |  |  |
| Income on securities                       | -  | -  |
| Impairment charge on investment securities | -  | (336,625)  |
| Included in other comprehensive income     | 37,150   | 223,100  |
| Transfers in and/or out of Level 3         | -  | -  |
| Ending balance June 30                     | \$ 371,735   | \$ 397,955   |

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

|   | Fair Value   | Fair Value Measurement at June 30, 2011<br>Using                                 |   |  |
|---|--------------|--|---|--|
|   |              | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial Assets:                       |              |  |   |  |
| Impaired Loans                          |              |  |   |  |
| Commercial, financial and agricultural: |              |  |   |  |
| Commercial and industrial               | \$ 3,130,000 | \$ -   | \$ -  | \$ 3,130,000                                       |
| Commercial mortgages:                   |              |  |   |  |
| Construction                            | -            | -  | -   | -  |
| Other                                   | 400,736      | -  | -   | 400,736  |
| Total Impaired Loans                    | \$ 3,530,736 | \$ -   | \$ -  | \$ 3,530,736                                       |
| Other real estate owned, net            | \$ 429,861   | \$ -   | \$ -  | \$ 429,861   |

| Financial Assets: | Fair Value | Fair Value Measurement at December 31,<br>2010<br>Using                          |   |  |
|-------------------|------------|--|---|--|
|                   |            | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                   |            |  |   |  |

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|                                     | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------------|--|---|--|
| <b>Impaired Loans:</b>              |  |   |  |
| <b>Commercial mortgages:</b>        |  |   |  |
| Construction                        | \$ 72,211  | \$ -  | \$ 72,211  |
| Other                               | 580,329  | -   | 580,329  |
| <b>Total Impaired Loans</b>         | <b>\$ 652,540</b>  | <b>\$ -</b>   | <b>\$ 652,540</b>                                  |
| <b>Other real estate owned, net</b> | <b>\$ 740,620</b>  | <b>\$ -</b>   | <b>\$ 740,620</b>                                  |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$4,414,654 with a valuation allowance of \$883,918 as of June 30, 2011, resulting in a \$250,000 provision for loan losses for the six-month period ending June 30, 2011.

OREO, which is measured by the lower of carrying or fair value less costs to sell, had a net carrying amount of \$429,861 at June 30, 2011. The net carrying amount reflects the outstanding balance of \$540,428 net of a valuation allowance of \$110,567 at June 30, 2011 and no write downs resulted for the six-month period ending June 30, 2011.

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$892,298, with a valuation allowance of \$239,758 as of December 31, 2010, resulting in no additional provision for loan losses for the year ending December 31, 2010.

OREO, which is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of \$740,620 at December 31, 2010. The net carrying amount reflected an outstanding balance of \$909,947, net of a valuation allowance of \$169,327 at December 31, 2010 which resulted in write downs of \$169,327 for the year ending December 31, 2010.

The carrying amounts and estimated fair values of other financial instruments, at June 30, 2011 and December 31, 2010, are as follows:

| (dollars in thousands)                                    | June 30, 2011   |                          | December 31, 2010 |                          |
|---|-----------------|--------------------------|-------------------|--------------------------|
|   | Carrying Amount | Estimated Fair Value (1) | Carrying Amount   | Estimated Fair Value (1) |
| <b>Financial assets:</b>                                  |                 |                          |                   |                          |
| Cash and due from financial institutions                  | \$ 27,787       | \$ 27,787                | \$ 16,540         | \$ 16,540                |
| Interest-bearing deposits in other financial institutions | 56,156          | 56,156                   | 44,080            | 44,080                   |
| Securities available for sale                             | 284,134         | 284,134                  | 223,545           | 223,545                  |
| Securities held to maturity                               | 8,041           | 8,792                    | 7,715             | 8,297                    |
| Federal Home Loan and Federal Reserve Bank stock          | 4,724           | N/A                      | 3,329             | N/A                      |
| Net loans   | 778,964         | 796,374                  | 604,186           | 618,859                  |
| Loans held for sale                                       | 351             | 351                      | 487               | 487                      |
| Accrued interest receivable                               | 3,775           | 3,775                    | 2,713             | 2,713                    |
| <b>Financial liabilities:</b>                             |                 |                          |                   |                          |
| <b>Deposits:</b>  |                 |                          |                   |                          |
| Demand, savings, and insured money market accounts        | 696,077         | 696,077                  | 532,555           | 532,555                  |
| Time deposits   | 317,885         | 320,824                  | 253,804           | 256,281                  |
| Securities sold under agreements to repurchase            | 42,218          | 44,216                   | 44,775            | 46,667                   |
| Federal Home Loan Bank advances                           | 44,096          | 46,891                   | 20,000            | 21,609                   |
| Accrued interest payable                                  | 927             | 927                      | 784               | 784                      |
| Dividends payable   | 1,142           | 1,142                    | 881               | 881                      |

(1) Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.



The methods and assumptions used to estimate fair value are described as follows:

Carrying amount is the estimated fair value for cash and due from financial institutions, interest bearing deposits, accrued interest receivable and payable, demand deposits, short-term debt, and variable rate loans or deposits that reprice frequently and fully. The methods for determining the fair values for securities were described previously. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. The fair value of off-balance-sheet items is not considered material.

#### 4. Goodwill and Intangible Assets

The changes in goodwill included in the core banking segment during the periods ending June 30, 2011 and 2010 were as follows:

|                   | 2011          | 2010         |
|-------------------|---------------|--------------|
| Beginning of year | \$ 9,872,375  | \$ 9,872,375 |
| Acquired goodwill | 12,678,715    | -            |
| June 30,          | \$ 22,551,090 | \$ 9,872,375 |

Acquired intangible assets were as follows at June 30, 2011 and December 31, 2010:

|   | At June 30, 2011    |                             | At December 31, 2010 |                             |
|---|---------------------|-----------------------------|----------------------|-----------------------------|
|   | Balance<br>Acquired | Accumulated<br>Amortization | Balance<br>Acquired  | Accumulated<br>Amortization |
| Core deposit<br>intangibles                   | \$ 3,819,798        | \$ 887,305                  | \$ 1,174,272         | \$ 674,141                  |
| Other customer<br>relationship<br>intangibles | 6,063,423           | 2,229,375                   | 6,133,116            | 1,977,347                   |
| Total   | \$ 9,883,221        | \$ 3,116,680                | \$ 7,307,388         | \$ 2,651,488                |

Aggregate amortization expense for the six-month period ended June 30, 2011 was \$465,192. Aggregate amortization expense for the six-month period ended June 30, 2010 was \$370,168.

The remaining estimated aggregate amortization expense at June 30, 2011 is listed below:

| Year                   | Estimated<br>Expense |
|------------------------|----------------------|
| 2011                   | \$ 576,001           |
| 2012                   | 1,046,720            |
| 2013                   | 876,524              |
| 2014                   | 777,801              |
| 2015                   | 681,176              |
| 2016 and<br>thereafter | 2,808,319            |
| Total                  | \$ 6,766,541         |



## 5. Business Combinations

## Acquisition of Fort Orange Financial Corp.

On April 8, 2011, the Corporation completed its merger with Fort Orange Financial Corp. (“FOFC”), the holding company of Capital Bank & Trust Company (“Capital Bank”) based in Albany, New York, with FOFC being merged with and into the Corporation, and the Corporation being the surviving entity. Immediately following the merger, Capital Bank was merged with and into the Bank.

As of the date of the merger, Capital Bank’s unaudited balance sheet included approximately \$254 million in assets, a loan portfolio approximating \$171 million and deposits of \$199 million. With the completion of the acquisition, the Corporation became a \$1.2 billion financial institution with 28 offices located in eight New York counties, as well as Bradford County in Pennsylvania. The Capital Bank branch locations are in Albany, Clifton Park, Latham and Slingerlands.

Under the terms of an Agreement and Plan of Merger (the “Agreement”) entered into on October 14, 2010, the Corporation purchased all of the outstanding shares of FOFC common stock in a stock and cash transaction valued at \$31.9 million, based upon the Corporation’s closing stock price on April 8, 2011 of \$23.50. For each share of FOFC common stock outstanding immediately prior to the merger, each FOFC shareholder had the right to elect to receive: (i) all cash in the amount of \$7.50 per share (“Cash Consideration”), (ii) all stock at an exchange ratio of 0.3571 of a share of the Corporation’s common stock for each share of FOFC common stock (“Stock Consideration”) or (iii) a mix of Cash Consideration for 25% of their shares and Stock Consideration for 75% of their shares. The total consideration to be paid by the Corporation was subject to the requirement that 25% of the FOFC common stock be acquired for the Cash Consideration and 75% be acquired for the Stock Consideration. As a result of the merger, the Corporation issued approximately 1.01 million additional shares of its common stock.

The table below illustrates the reconciliation of shares outstanding and the calculation of the consideration effectively transferred.

|   |           |
|---|-----------|
| Reconciliation of Shares Outstanding  |           |
| FOFC shares outstanding at April 8, 2011  | 3,771,425 |
| Percentage of stock consideration   | 75%       |
| FOFC shares exchanged for stock   | 2,828,569 |
| Exchange Ratio  | 0.3571    |
| Chemung Financial shares issued to FOFC shareholders (excludes fractional shares)             | 1,009,942 |
| Chemung Financial shares outstanding April 8, 2011  | 3,565,610 |
| Total Chemung Financial Shares at April 8, 2011 following the consummation of the transaction | 4,575,552 |
| Ownership % held by FOFC shareholders   | 22%       |
| Ownership % held by legacy Chemung Financial shareholders                                     | 78%       |

Purchase Price Consideration (dollar amounts in thousands, except per share data)

|  |    |           |
|--|----|-----------|
| FOFC shares outstanding at April 8, 2011   |    | 3,771,425 |
| Percentage of stock consideration  |    | 75%       |
| FOFC shares exchanged for stock  |    | 2,828,569 |
| Exchange Ratio   |    | 0.3571    |
| Chemung Financial shares issued to FOFC shareholders<br>(excludes fractional shares) |    | 1,009,942 |
| Purchase price per Chemung Financial common share                                    | \$ | 23.50     |
| Total stock consideration paid   | \$ | 23,734    |
| Total cash consideration paid  |    | 6,939     |
| Cash paid for fractional shares  |    | 3         |
| Cash paid for the settlement of FOFC stock options                                   |    | 545       |
| Cash paid for severance payments   |    | 650       |
| Total consideration paid   | \$ | 31,871    |

As a result of the FOFC merger, we recognized assets acquired and liabilities assumed at their acquisition date fair value as presented below: (in thousands).

|                      |    |        |
|----------------------|----|--------|
| Total Purchase Price | \$ | 31,871 |
|----------------------|----|--------|

Net assets acquired:

|   |    |           |
|---|----|-----------|
| Cash and due from banks                 | \$ | 33,285    |
| Securities available for sale           |    | 46,525    |
| Federal Home Loan Bank Stock            |    | 1,578     |
| Loans                                   |    | 164,243   |
| Accrued Interest Receivable             |    | 864       |
| Premises and equipment                  |    | 879       |
| Core deposit intangible                 |    | 2,646     |
| Deferred tax asset                      |    | 2,466     |
| Other assets                            |    | 3,046     |
| Deposits                                |    | (200,468) |
| Borrowings                              |    | (34,823)  |
| Accrued Interest Payable                |    | (304)     |
| Other liabilities                       |    | (745)     |
| Net assets acquired                     | \$ | 19,192    |
| Goodwill resulting from the FOFC merger | \$ | 12,679    |

The goodwill generated by the FOFC merger consists of, among other things, synergies and increased economies of scale, including the ability to offer more diverse and profitable products, greater diversity in the branch system which may lead to lower cost deposits, and an increased legal lending limit. We expect that no goodwill recognized as a result of the FOFC merger will be deductible for income tax purposes. Purchase accounting adjustments are subject to refinement as management finalizes their fair value measurements, including their analysis of identifiable intangible assets. Since the branches acquired were merged into the bank, there is no segment impact of the FOFC merger.



The fair value of the financial assets acquired included loans receivable with an unpaid principal balance of \$170.7 million. U.S. generally accepted accounting principles (“U.S. GAAP”) prohibits carrying over an allowance for loan losses for loans purchased in the merger. The table below illustrates the fair value adjustments made to the unpaid principal balance in order to present a fair value of the loans acquired (in thousands).

|   |            |
|---|------------|
| Gross loans-unpaid principal balance at April 8, 2011                   | \$ 170,682 |
| Fair value adjustment on pools of homogeneous loans                     | (1,619)    |
| Credit fair value adjustment on loans with deteriorating credit quality | (4,820)    |
| Fair value of purchased loans at April 8, 2011                          | \$ 164,243 |

The fair value adjustment on pools of homogeneous loans represents adjustments a prospective acquirer would make to the unpaid principal balance to account for differences between the contractual yield on the portfolio and market interest rates, for credit, and for liquidity. The market rate adjustment represents the movement in market interest rates, irrespective of credit adjustments, compared to the stated rates of the acquired loans. The credit adjustment made on pools of homogeneous loans represents the changes in credit quality of the underlying borrowers from the loan inception to the merger date. The credit adjustment on loans with deteriorating credit quality is derived in accordance with Accounting Standard Codification 310-30, “Loans and Debt Securities Acquired with Deteriorated Credit Quality” and represents the portion of the loan balance that has been deemed uncollectible based on our expectations of future cash flows for each respective loan.

The information below presents the recorded fair value on April 8, 2011 of the Corporation’s purchased impaired loans with the accretable and non-accretable related adjustments from the perspective of total contractual cash flows (in thousands).

|  |           |
|--|-----------|
| Contractually required principal and interest at acquisition                 | \$ 25,718 |
| Contractual cash flows not expected to be collected (nonaccretable discount) | (5,849)   |
| Expected cash flows at acquisition   | 19,869    |
| Interest component of expected cash flows (accretable yield)                 | (1,861)   |
| Fair value of loans acquired with deteriorating credit quality               | \$ 18,008 |

The results of operations of the merged entity have been reflected in Chemung Financial Corporation’s consolidated statements of income beginning as of the acquisition date. Pro forma condensed consolidated income statements for the three and six months ended June 30, 2011 and 2010 as if the merger occurred at the beginning of each period presented are as follows (in thousands):

|   | Six Months Ended |           | Three Months Ended |           |
|---|------------------|-----------|--------------------|-----------|
|   | June 30,         |           | June 30,           |           |
| Financial assets:                                   | 2011             | 2010      | 2011               | 2010      |
| Interest and dividend income                        | \$ 26,821        | \$ 28,515 | \$ 13,509          | \$ 14,265 |
| Interest expense                                    | 4,275            | 6,681     | 1,850              | 3,199     |
| Net interest income                                 | 22,546           | 21,834    | 11,659             | 11,066    |
| Provision for loan losses                           | 1,225            | 1,675     | 125                | 695       |
| Net interest income after provision for loan losses | 21,321           | 20,159    | 11,534             | 10,371    |
| Non-interest income                                 | \$ 9,144         | \$ 9,055  | \$ 4,747           | \$ 4,729  |
| Non-interest expense                                | 22,180           | 21,673    | 11,490             | 10,943    |
| Income before income taxes                          | 8,285            | 7,541     | 4,791              | 4,157     |

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|                                      |          |          |          |          |
|--------------------------------------|----------|----------|----------|----------|
| Income tax expense                   | 2,718    | 2,427    | 1,606    | 1,345    |
| Net income                           | \$ 5,567 | \$ 5,114 | \$ 3,185 | \$ 2,812 |
| Weighted average shares outstanding  | 4,629    | 4,616    | 4,629    | 4,614    |
| Basic and diluted earnings per share | \$ 1.20  | \$ 1.11  | \$ 0.69  | \$ 0.61  |

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The consolidated income statement for the Corporation includes \$2.718 million of net interest income, \$28 thousand of non-interest income and net income of \$1.115 million of the acquiree since the acquisition date.

## 6. Comprehensive Income

Comprehensive income or loss of the Corporation represents net income plus other comprehensive income or loss, which consists of the net change in unrealized holding gains or losses on securities available for sale and the change in the funded status of the Corporation's defined benefit pension plan and other benefit plans, net of the related tax effect. Accumulated other comprehensive income or loss represents the net unrealized holding gains or losses on securities available for sale and the funded status of the Corporation's defined benefit pension plan and other benefit plans, as of the consolidated balance sheet dates, net of the related tax effect.

Comprehensive income for the three and six-month periods ended June 30, 2011 was \$5,141,830 and \$7,241,361, respectively. Comprehensive income for the three and six-month periods ended June 30, 2010 was \$3,667,644 and \$6,525,784, respectively. The following summarizes the components of other comprehensive income:

|   | Six Months Ended<br>June 30, |              | Three Months Ended<br>June 30, |              |
|---|------------------------------|--------------|--------------------------------|--------------|
|   | 2011                         | 2010         | 2011                           | 2010         |
| Other Comprehensive Income  |                              |              |                                |              |
| Unrealized holding gains on securities available for sale   | \$ 5,191,291                 | \$ 3,173,635 | \$ 4,443,919                   | \$ 2,068,572 |
| Change in unrealized gains (losses) on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in earnings, net of reclassification | -                            | 223,100      | -                              | 105,435      |
| Reclassification adjustment net gains realized in net income  | (679,209)                    | (451,094)    | (485,811)                      | (451,094)    |
| Net unrealized gains  | 4,512,082                    | 2,945,641    | 3,958,108                      | 1,722,913    |
| Tax effect  | 1,745,544                    | 1,139,549    | 1,531,234                      | 666,526      |
| Net of tax amount   | \$ 2,766,538                 | \$ 1,806,092 | \$ 2,426,874                   | \$ 1,056,387 |
| Change in funded status of defined benefit pension plan and other benefit plans   | 309,398                      | 353,094      | 154,699                        | 176,547      |
| Tax effect  | 119,694                      | 136,598      | 59,847                         | 68,299       |
| Net of tax amount   | 189,704                      | 216,496      | 94,852                         | 108,248      |
| Total other comprehensive income  | \$ 2,956,242                 | \$ 2,022,588 | \$ 2,521,726                   | \$ 1,164,635 |

The following is a summary of the accumulated other comprehensive income balance, net of tax:

|  | Balance at<br>December 31,<br>2010 | Current<br>Period<br>Change | Balance at<br>June 30, 2011 |
|--|------------------------------------|-----------------------------|-----------------------------|
| Unrealized gains on securities available for sale        | \$ 5,661,013                       | \$ 2,766,538                | \$ 8,427,551                |
| Unrealized loss on pension plans and other benefit plans | (5,558,538)                        | 189,704                     | (5,368,834)                 |
| Total  | \$ 102,475                         | \$ 2,956,242                | \$ 3,058,717                |

## 7. Commitments and Contingencies

The Corporation is a party to certain financial instruments with off-balance sheet risk such as commitments under standby letters of credit, unused portions of lines of credit, overdraft protection and commitments to fund new loans. In accordance with U.S. GAAP, these financial instruments are not recorded in the financial statements. The Corporation's policy is to record such instruments when funded. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are generally used by the Corporation to manage clients' requests for funding and other client needs.

Also in the normal course of business, there are various outstanding claims and legal proceedings involving the Corporation or its subsidiaries. On February 14 and April 14, 2011, the Bank received separate settlement demands from representatives of beneficiaries of certain trusts for which the Bank has acted as trustee. The settlement demands relate to alleged claims of, among other things, breach of the Bank's fiduciary duties as trustee, including the Bank's alleged failure to adequately diversify the relevant trust portfolios. The beneficiaries seek aggregate damages of up to approximately \$27.0 million. While none of the potential claims have been asserted in court, management believes it is probable that some or all of the claims will be asserted in the future. Although these matters are inherently unpredictable, management will defend any claims vigorously and has concluded that it is reasonably possible, but not probable, that the financial position, results of operations or cash flows of the Corporation could be materially adversely affected in any particular period by the unfavorable resolution of these as yet unasserted claims. Accordingly, no liabilities have been accrued in the Corporation's financial statements with respect to the unasserted claims.

## 8. Securities

Amortized cost and estimated fair value of securities available for sale are as follows:

|   | June 30, 2011         |                      |                      |                         |
|---|-----------------------|----------------------|----------------------|-------------------------|
|   | Amortized<br>Cost     | Unrealized<br>Gains  | Unrealized<br>Losses | Estimated<br>Fair Value |
| Obligations of U.S. Government and U.S.<br>Government sponsored enterprises | \$ 135,742,036        | \$ 2,822,888         | \$ -                 | \$ 138,564,924          |
| Mortgage-backed securities, residential                                     | 58,827,886            | 3,027,069            | 1,169                | 61,853,786              |
| Collateralized Mortgage obligations   | 8,998,635             | 212,238              | 5,404                | 9,205,469               |
| Obligations of states and political subdivisions                            | 47,110,056            | 1,497,448            | 4,647                | 48,602,857              |
| Corporate bonds and notes   | 13,988,649            | 667,300              | 30,091               | 14,625,858              |
| SBA loan pools  | 2,331,536             | 38,887               | -                    | 2,370,423               |
| Trust Preferred securities  | 2,601,808             | 144,831              | 351,310              | 2,395,329               |
| Corporate stocks  | 788,219               | 5,734,023            | 7,158                | 6,515,084               |
| <b>Total</b>  | <b>\$ 270,388,825</b> | <b>\$ 14,144,684</b> | <b>\$ 399,779</b>    | <b>\$ 284,133,730</b>   |

|   | Amortized<br>Cost | December 31, 2010   |                      | Estimated<br>Fair Value |
|---|-------------------|---------------------|----------------------|-------------------------|
|   |                   | Unrealized<br>Gains | Unrealized<br>Losses |                         |
| Obligations of U.S. Government and U.S.<br>Government sponsored enterprises | \$ 101,426,799    | \$ 916,547          | \$ 211,829           | \$ 102,131,517          |
| Mortgage-backed securities, residential                                     | 60,379,269        | 2,385,036           | 2,672                | 62,761,633              |
| Obligations of states and political subdivisions                            | 38,143,972        | 672,067             | 50,947               | 38,765,092              |
| Corporate bonds and notes   | 11,019,343        | 674,847             | -                    | 11,694,190              |
| Trust Preferred securities  | 2,597,993         | 134,561             | 388,460              | 2,344,094               |
| Corporate stocks  | 744,763           | 5,112,755           | 9,082                | 5,848,435               |
| Total   | \$ 214,312,139    | \$ 9,895,813        | \$ 662,990           | \$ 223,544,961          |

Amortized cost and estimated fair value of securities held to maturity are as follows:

|  | Amortized<br>Cost | June 30, 2011       |                      | Estimated<br>Fair Value |
|--|-------------------|---------------------|----------------------|-------------------------|
|  |                   | Unrealized<br>Gains | Unrealized<br>Losses |                         |
| Obligations of states and political subdivisions | \$ 8,040,872      | \$ 751,589          | \$ -                 | \$ 8,792,461            |
| Total  | \$ 8,040,872      | \$ 751,589          | \$ -                 | \$ 8,792,461            |

|  | Amortized<br>Cost | December 31, 2010   |                      | Estimated<br>Fair Value |
|--|-------------------|---------------------|----------------------|-------------------------|
|  |                   | Unrealized<br>Gains | Unrealized<br>Losses |                         |
| Obligations of states and political subdivisions | \$ 7,715,123      | \$ 582,269          | \$ -                 | \$ 8,297,392            |
| Total  | \$ 7,715,123      | \$ 582,269          | \$ -                 | \$ 8,297,392            |

The amortized cost and estimated fair value of debt securities are shown by expected maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties:

|                                  | June 30, 2011      |                |                   |               |
|----------------------------------|--------------------|----------------|-------------------|---------------|
|                                  | Available for Sale |                | Held to Maturity  |               |
|                                  | Amortized<br>Cost  | Fair<br>Value  | Amortized<br>Cost | Fair<br>Value |
| Within One Year                  | \$ 53,786,224      | \$ 54,219,365  | \$ 2,163,515      | \$ 2,191,516  |
| After One, But Within Five Years | 180,767,175        | 187,110,336    | 3,472,107         | 3,827,144     |
| After Five, But Within Ten Years | 31,383,828         | 32,861,862     | 2,405,250         | 2,773,801     |
| After Ten Years                  | 3,663,379          | 3,427,083      | -                 | -             |
| Total                            | \$ 269,600,606     | \$ 277,618,646 | \$ 8,040,872      | \$ 8,792,461  |

Proceeds from sales and calls of securities available for sale for the three and six months ended June 30, 2011, were \$6,485,156 and \$56,656,054, respectively. Realized gross gains on these sales and calls were \$485,811 and \$679,209 during the three and six month periods ended June 30, 2011, respectively. There were no sales or calls of securities available for sale that resulted in losses for the three or six-months ended June 30, 2011.

Proceeds from sales and calls of securities available for sale for the three and six months ended June 30, 2010, were \$12,545,459 and \$30,440,459, respectively. Realized gross gains on these sales and calls were \$451,094 during the three and six month periods ended June 30, 2010. There were no sales or calls of securities available for sale that resulted in losses for the three or six-months ended June 30, 2010.

The following table summarizes the investment securities available for sale and held to maturity with unrealized losses at June 30, 2011 and December 31, 2010 by aggregated major security type and length of time in a continuous unrealized loss position:

| June 30, 2011                                    | Less than 12 months |                   | 12 months or longer |                   | Total        |                   |
|--|---------------------|-------------------|---------------------|-------------------|--------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value   | Unrealized Losses |
| Mortgage-backed securities, residential          | \$ 215,776          | \$ 1,169          | \$ -                | \$ -              | \$ 215,776   | \$ 1,169          |
| Collateralized mortgage obligations              | 943,092             | 5,404             | -                   | -                 | 943,092      | 5,404             |
| Obligations of states and political subdivisions | 937,225             | 4,647             | -                   | -                 | 937,225      | 4,647             |
| Corporate bonds and notes                        | 748,858             | 30,091            | -                   | -                 | 748,858      | 30,091            |
| Trust preferred securities                       | -                   | -                 | 371,735             | 351,310           | 371,735      | 351,310           |
| Corporate stocks                                 | 3,353               | 284               | 43,118              | 6,874             | 46,471       | 7,158             |
| Total temporarily impaired securities            | \$ 2,848,304        | \$ 41,595         | \$ 414,853          | \$ 358,184        | \$ 3,263,157 | \$ 399,779        |

| December 31, 2010  | Less than 12 months |                   | 12 months or longer |                   | Total         |                   |
|--|---------------------|-------------------|---------------------|-------------------|---------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value    | Unrealized Losses |
| Obligations of U.S. Government and US Government sponsored enterprises | \$ 25,543,154       | \$ 211,829        | \$ -                | \$ -              | \$ 25,543,154 | \$ 211,829        |
| Mortgage-backed securities, residential                                | 844,587             | 2,672             | -                   | -                 | 844,587       | 2,672             |
| Obligations of states and political subdivisions                       | 7,746,912           | 50,947            | -                   | -                 | 7,746,912     | 50,947            |
| Trust preferred securities   | -                   | -                 | 334,585             | 388,460           | 334,585       | 388,460           |
| Corporate stocks   | -                   | -                 | 40,910              | 9,082             | 40,910        | 9,082             |
|  | \$ 34,134,653       | \$ 265,448        | \$ 375,495          | \$ 397,542        | \$ 34,510,148 | \$ 662,990        |



### Other-Than-Temporary-Impairment

In determining OTTI for debt securities, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Corporation has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

In order to determine OTTI for purchased beneficial interests, the Corporation compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

When OTTI occurs, for either debt securities or purchased beneficial interests, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

As of June 30, 2011, the majority of the Corporation's unrealized losses in the investment securities portfolio related to two pooled trust preferred securities. The decline in fair value on these securities is primarily attributable to the financial crisis and resulting credit deterioration and financial condition of the underlying issuers, all of which are financial institutions. This deterioration may affect the future receipt of both principal and interest payments on these securities. This fact combined with the current illiquidity in the market makes it unlikely that the Corporation would be able to recover its investment in these securities if the securities were sold at this time.

Our analysis of these investments includes \$723 thousand book value of collateralized debt obligations ("CDO's") consisting of pooled trust preferred securities. These securities were rated high quality at inception, but at June 30, 2011 Moody's rated these securities as Caa3, which is defined as substantial risk of default. The Corporation uses the OTTI evaluation model to compare the present value of expected cash flows to the previous estimate to determine if there are adverse changes in cash flows during the quarter. The OTTI model considers the structure and term of the CDO and the financial condition of the underlying issuers. Specifically, the model details interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. Assumptions used in the model include expected future default rates and prepayments. We assume no recoveries on defaults and treat all interest payment deferrals as defaults.





In determining the amount of "currently performing" collateral for the purposes of modeling the expected future cash flows, management analyzed the default and deferral history over the past 3 years in both of the securities held. This review indicated significant increases in the number and amount of defaults and deferrals by the issuers. Additionally, management has noted the correlation between the rising levels of non-performing loans as a percent of tangible equity plus loan loss reserves by those issuers that have defaulted and/or deferred interest payments. Therefore management has used this ratio as a primary indicator to project the levels of future defaults for modeling purposes. Management recognizes the potential of defaults and deferrals to continue over the next 12 to 24 months. The operating environment remains difficult for community and regional banks in many parts of the country, which could lead to higher default and deferral levels. Forty-Eight depository institutions were closed by regulators during the first six months of 2011.

The following table provides detailed information related to the pooled trust preferred securities held as of June 30, 2011:

| Description                               | Actual<br>Deferrals as<br>% of<br>Outstanding<br>Collateral | Actual<br>Defaults as<br>% of<br>Original<br>Collateral | Excess<br>Subordination as<br>% of Performing<br>Collateral | Expected<br>Additional<br>Defaults as %<br>of Performing<br>Collateral |
|---|---|---|---|--|
| MM Community Funding IX, Ltd. (Class B-2) | 23.04%  | 17.05%  | -60.80%   | 25.43%   |
| TPREF Funding II, Ltd. (Class B)          | 20.97%  | 14.24%  | -44.32%   | 14.28%   |

In the table above, "Excess Subordination as % of Performing Collateral" was calculated by dividing the difference between the total face value of performing collateral less the face value of all outstanding note balances not subordinate to our investment, by the total face value of performing collateral. This ratio measures the extent to which there may be tranches within each pooled trust preferred structure available to absorb credit losses before the Corporation's securities would be impacted. As mentioned earlier, the levels of defaults and deferrals in these pools have increased significantly in recent months, which have resulted in a significant reduction in the amount of performing collateral. As a result, the negative Excess Subordination as a % of Performing Collateral percentages shown above indicate there is no support from subordinate tranches available to absorb losses before the Corporation's securities would be impacted. A negative ratio is not the only factor to consider when determining if OTTI should be recorded. Other factors affect the timing and amount of cash flows available for payments to investors such as the excess interest paid by the issuers, as issuers typically pay higher rates of interest than are paid out to investors.

Upon completion of the June 30, 2011 analysis, our model indicated no additional other-than-temporary impairment on these securities. Both of these securities remained classified as available for sale and represented \$351 thousand of the unrealized losses reported at June 30, 2011. Payments continue to be made as agreed on the TPREF Funding II security, however the Corporation learned early in August 2011 that the MM Community Funding IX security was officially in default and the quarterly interest payment would not be made as scheduled. This action had no material impact to the financial statements as of June 30, 2011 and no future interest will be accrued on this security.

When the analysis of these securities was conducted at June 30, 2011, the present value of expected future cash flows using a discount rate equal to the yield in effect at the time of purchase was compared to the previous quarters' analysis. This analysis indicated no further decline in value attributed to credit related factors stemming from any further deterioration in the underlying collateral payment streams in either security held. Additionally, the present value of the expected future cash flows was calculated using a current estimated discount rate that a willing market participant might use to value the securities based on current market conditions and interest rates. This comparison indicated a slight increase in value during the quarter, based on factors other than credit which resulted in a gain reported in other comprehensive income. This result is consistent with the fact that some improvement has been noted recently in the credit markets related to overall corporate and financial institution credit spreads. Therefore, while the credit quality related to these securities remained stable during the quarter, the change in value related to other factors actually improved and resulted in this increase in the overall fair value of the impaired securities. Changes in credit quality may or may not correlate to changes in the overall fair value of the impaired securities as the change in credit quality is only one component in assessing the overall fair value of the impaired securities. Therefore the recognition of additional credit related OTTI could result in a gain reported in other comprehensive income. Total other-than-temporary impairment recognized in accumulated other comprehensive income was \$214,680 and \$233,895 for securities available for sale at June 30, 2011 and June 30, 2010, respectively.

The table below presents a roll forward of the cumulative credit losses recognized in earnings for the three and six-month periods ending June 30, 2011 and 2010:

|   | 2011         | 2010         |
|---|--------------|--------------|
| Beginning balance, January 1,   | \$ 3,438,673 | \$ 3,045,668 |
| Amounts related to credit loss for which an other-than-temporary impairment was not previously recognized   | -            | -            |
| Additions/Subtractions:   |              |              |
| Amounts realized for securities sold during the period  | -            | -            |
| Amounts related to securities for which the company intends to sell or that it will be more likely than not that the company will be required to sell prior to recovery of amortized cost basis | -            | -            |
| Reductions for increase in cash flows expected to be collected that are recognized over the remaining life of the security  | -            | -            |
| Increases to the amount related to the credit loss for which other-than-temporary impairment was previously recognized  | -            | 336,625      |
| Ending balance, June 30,  | \$ 3,438,673 | \$ 3,382,293 |
| Beginning balance, April 1,   | \$ 3,438,673 | \$ 3,306,193 |
| Amounts related to credit loss for which an other-than-temporary impairment was not previously recognized   | -            | -            |
| Additions/Subtractions:   |              |              |
| Amounts realized for securities sold during the period  | -            | -            |
| Amounts related to securities for which the company intends to sell or that it will be more likely than not that the company will be required to sell prior to recovery of amortized cost basis | -            | -            |
| Reductions for increase in cash flows expected to be collected that are recognized over the remaining life of the security  | -            | -            |
| Increases to the amount related to the credit loss for which other-than-temporary impairment was previously recognized  | -            | 76,100       |

|                          |              |              |
|--------------------------|--------------|--------------|
| Ending balance, June 30, | \$ 3,438,673 | \$ 3,382,293 |
|--------------------------|--------------|--------------|

## 9. Loans and Allowance for Loan Losses

The composition of the loan portfolio is summarized as follows:

|  | June 30, 2011  | December 31, 2010 |
|--|----------------|-------------------|
| Commercial, financial and agricultural | \$ 159,906,838 | \$ 114,697,440    |
| Commercial mortgages                   | 238,003,579    | 133,070,484       |
| Residential mortgages                  | 195,150,301    | 173,467,806       |
| Indirect consumer loans                | 96,699,376     | 98,940,854        |
| Consumer loans                         | 98,959,933     | 93,507,785        |
|  | \$ 788,720,027 | \$ 613,684,369    |

Loans are charged against the allowance for loan losses when management believes that the collectability of all or a portion of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb probable incurred losses on existing loans. Management's evaluation of the adequacy of the allowance for loan losses is performed on a periodic basis and takes into consideration such factors as the credit risk grade assigned to the loan, historical loan loss experience and review of specific problem loans (including evaluations of the underlying collateral). Historical loss experience is adjusted by management based on their judgment as to the current impact of qualitative factors including changes in the composition and volume of the loan portfolio, overall portfolio quality, and current economic conditions that may affect the borrowers' ability to pay. Management believes that the allowance for loan losses is adequate to absorb probable incurred losses. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Management, after considering current information and events regarding the borrower's ability to repay their obligations, classifies a loan as impaired when it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. Loans not impaired but classified as substandard and special mention use a historical loss factor on a rolling five year history of net losses. For all other unclassified loans, the historical loss experience is determined by portfolio class and is based on the actual loss history experienced by the Corporation over the most recent two years. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio class. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, financial and agricultural; commercial mortgages; residential mortgages; and consumer loans.

#### Risk Characteristics

Commercial, financial and agricultural loans primarily consist of loans to small to mid-sized businesses in our market area in a diverse range of industries. These loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value. The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower's operations or on the value of underlying collateral, if any.

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, inferring higher potential losses on an individual customer basis. Loan repayment is often dependent on the successful operation and management of the properties and/or the businesses occupying the properties, as well as on the collateral securing the loan. Economic events or conditions in the real estate market could have an adverse impact on the cash flows generated by properties securing the Company's commercial real estate loans and on the value of such properties.

Residential mortgage loans are generally made on the basis of the borrower's ability to make repayment from his or her employment and other income, but are secured by real property whose value tends to be more easily ascertainable. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers and the nature of the loan collateral.

The consumer loan segment includes home equity lines of credit and home equity loans, which exhibit many of the same risk characteristics as residential mortgages. Indirect and other consumer loans may entail greater credit risk than residential mortgage and home equity loans, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles or boats. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, thus are more likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

No allowance for loan losses was recorded as of June 30, 2011 for loans acquired as part of the FOFC merger. These loans were recorded at fair value at the time of the acquisition.



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Activity in the allowance for loan losses by class of loans was as follows:

| Six Months Ended June 30, 2011 |  |                      |                       |                |             |              |
|--------------------------------|--|----------------------|-----------------------|----------------|-------------|--------------|
| Allowance for loan losses      | Commercial, Financial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Unallocated | Total        |
| Beginning balance:             | \$ 2,118,299                           | \$ 2,575,058         | \$ 1,301,780          | \$ 2,727,022   | \$ 775,972  | \$ 9,498,131 |
| Charge Offs:                   | (3,003)                                | (3,764)              | -                     | (340,655)      | -           | (347,422)    |
| Recoveries:                    | 205,406                                | 26,103               | 30,324                | 93,130         | -           | 354,963      |
| Net charge offs                | 202,403                                | 22,339               | 30,324                | (247,525)      | -           | 7,541        |
| Provision                      | 760,731                                | 15,258               | (85,224)              | (182,038)      | (258,727)   | 250,000      |
| Ending balance                 | \$ 3,081,433                           | \$ 2,612,655         | \$ 1,246,880          | \$ 2,297,459   | \$ 517,245  | \$ 9,755,672 |

| Three Months Ended June 30, 2011 |  |                      |                       |                |             |              |
|----------------------------------|--|----------------------|-----------------------|----------------|-------------|--------------|
| Allowance for loan losses        | Commercial, Financial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Unallocated | Total        |
| Beginning balance:               | \$ 2,509,076                           | \$ 2,650,309         | \$ 1,366,214          | \$ 2,424,312   | \$ 641,040  | \$ 9,590,951 |
| Charge Offs:                     | (3,003)                                | -                    | -                     | (133,744)      | -           | (136,747)    |
| Recoveries:                      | 87,941                                 | 23,350               | 15,845                | 49,332         | -           | 176,468      |
| Net charge offs                  | 84,938                                 | 23,350               | 15,845                | (84,412)       | -           | 39,721       |
| Provision                        | 487,419                                | (61,004)             | (135,179)             | (42,441)       | (123,795)   | 125,000      |
| Ending balance                   | \$ 3,081,433                           | \$ 2,612,655         | \$ 1,246,880          | \$ 2,297,459   | \$ 517,245  | \$ 9,755,672 |

|                    | Three Months Ended June 30, 2010 | Six Months Ended June 30, 2010 |
|--------------------|----------------------------------|--------------------------------|
| Beginning balance: | \$ 10,163,840                    | \$ 9,967,223                   |
| Charge offs:       | (233,841)                        | (585,241)                      |
| Recoveries:        | 142,292                          | 315,309                        |
| Net charge offs    | (91,549)                         | (269,932)                      |
| Provision          | 375,000                          | 750,000                        |
| Ending balance     | \$ 10,447,291                    | \$ 10,447,291                  |

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment based on impairment method as of June 30, 2011 and December 31, 2010:

| June 30, 2011                         |  |                      |                       |                |             |       |
|---------------------------------------|--|----------------------|-----------------------|----------------|-------------|-------|
| Allowance for loan losses             | Commercial, Financial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Unallocated | Total |
| Ending allowance balance attributable |  |                      |                       |                |             |       |



to loans:

|   |              |              |              |              |            |              |
|---|--------------|--------------|--------------|--------------|------------|--------------|
| Individually<br>evaluated for<br>impairment     | \$ 681,617   | \$ 202,301   | \$ -         | \$ -         | \$ -       | \$ 883,918   |
| Collectively<br>evaluated for<br>impairment     | 2,399,816    | 2,410,354    | 1,246,880    | 2,297,459    | 517,245    | 8,871,754    |
| Acquired with<br>deteriorated credit<br>quality | -            | -            | -            | -            | -          | -            |
| Total ending<br>allowance balance               | \$ 3,081,433 | \$ 2,612,655 | \$ 1,246,880 | \$ 2,297,459 | \$ 517,245 | \$ 9,755,672 |

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December 31, 2010

| Allowance for loan losses                       | Commercial, Financial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans      | Unallocated       | Total               |
|---|--|----------------------|-----------------------|---------------------|-------------------|---------------------|
| Ending allowance balance attributable to loans: |  |                      |                       |                     |                   |                     |
| Individually evaluated for impairment           | \$ 23,524                              | \$ 216,234           | \$ -                  | \$ -                | \$ -              | \$ 239,758          |
| Collectively evaluated for impairment           | 2,094,775                              | 2,358,824            | 1,301,780             | 2,727,022           | 775,972           | 9,258,373           |
| Acquired with deteriorated credit quality       | -                                      | -                    | -                     | -                   | -                 | -                   |
| <b>Total ending allowance balance</b>           | <b>\$ 2,118,299</b>                    | <b>\$ 2,575,058</b>  | <b>\$ 1,301,780</b>   | <b>\$ 2,727,022</b> | <b>\$ 775,972</b> | <b>\$ 9,498,131</b> |

June 30, 2011

| Loans:  | Commercial, Financial and Agricultural | Commercial Mortgages  | Residential Mortgages | Consumer Loans        | Total                 |
|---|--|-----------------------|-----------------------|-----------------------|-----------------------|
| Loans individually evaluated for impairment     | \$ 6,926,216                           | \$ 4,115,043          | \$ 333,482            | \$ -                  | \$ 11,374,741         |
| Loans collectively evaluated for impairment     | 120,954,264                            | 137,382,860           | 173,384,978           | 189,585,779           | \$ 621,307,881        |
| Loans acquired with deteriorated credit quality | -                                      | -                     | -                     | -                     | -                     |
| <b>Total ending loans balance</b>               | <b>\$ 128,880,480</b>                  | <b>\$ 141,497,903</b> | <b>\$ 173,718,460</b> | <b>\$ 189,585,779</b> | <b>\$ 632,682,622</b> |

December 31, 2010

| Loans:                                      | Commercial, Financial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total        |
|---|--|----------------------|-----------------------|----------------|--------------|
| Loans individually evaluated for impairment | \$ 3,215,761                           | \$ 4,450,882         | \$ 408,392            | \$ -           | \$ 8,075,035 |
|   | 111,778,238                            | 128,963,664          | 173,465,831           | 193,098,341    | 607,306,074  |

|   |                |                |                |                |                |
|---|----------------|----------------|----------------|----------------|----------------|
| Loans collectively<br>evaluated for<br>impairment     |                |                |                |                |                |
| Loans acquired with<br>deteriorated credit<br>quality | -              | -              | -              | -              | -              |
| Total ending loans<br>balance                         | \$ 114,993,999 | \$ 133,414,546 | \$ 173,874,223 | \$ 193,098,341 | \$ 615,381,109 |

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The following tables present loans individually evaluated for impairment recognized by class of loans as of June 30, 2011 and December 31, 2010, the average recorded investment and interest income recognized by class of loans as of the three and six month periods ending June 30, 2011:

|  | June 30, 2011                  |  |                        | Six Months Ended<br>June 30, 2011 |                                  | Three Months Ended<br>June 30, 2011 |                                  |
|--|--------------------------------|--|------------------------|-----------------------------------|----------------------------------|-------------------------------------|----------------------------------|
|  | Unpaid<br>Principal<br>Balance | Allowance<br>for Loan<br>Losses<br>Allocated | Recorded<br>Investment | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment   | Interest<br>Income<br>Recognized |
| With no related allowance recorded:<br>Commercial, financial and agricultural: |                                |  |                        |                                   |                                  |                                     |                                  |
| Commercial & industrial  | \$ 3,090,943                   | \$ -   | \$ 3,093,931           | \$3,141,620                       | \$ 18,759                        | \$3,116,317                         | \$ 10,933                        |
| Commercial mortgages:  |                                |  |                        |                                   |                                  |                                     |                                  |
| Construction   | 30,464                         | -  | 30,464                 | 31,128                            | -                                | 30,559                              | -                                |
| Other  | 3,488,055                      | -  | 3,486,675              | 3,451,644                         | -                                | 3,402,624                           | -                                |
| Residential mortgages  | 332,966                        | -  | 333,482                | 349,501                           | 5,640                            | 320,055                             | 3,266                            |
| With an allowance recorded:<br>Commercial, financial and agricultural:         |                                |  |                        |                                   |                                  |                                     |                                  |
| Commercial & industrial  | 3,811,617                      | 681,617                                      | 3,832,285              | 1,306,572                         | 144,242                          | 1,948,091                           | 144,242                          |
| Commercial mortgages:  |                                |  |                        |                                   |                                  |                                     |                                  |
| Construction   | 19,853                         | 19,853                                       | 19,853                 | 30,318                            | -                                | 20,008                              | -                                |
| Other  | 583,184                        | 182,448                                      | 578,051                | 703,733                           | -                                | 646,603                             | -                                |
| Total  | \$11,357,082                   | \$883,918                                    | \$11,374,741           | \$9,014,516                       | \$168,641                        | \$9,484,257                         | \$157,841                        |

|  | December 31, 2010              |  |                        |                                   |                                  |  |
|--|--------------------------------|--|------------------------|-----------------------------------|----------------------------------|--|
|  | Unpaid<br>Principal<br>Balance | Allowance<br>for Loan<br>Losses<br>Allocated | Recorded<br>Investment | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |  |
| With no related allowance recorded:<br>Commercial, financial and agricultural: |                                |  |                        |                                   |                                  |  |
| Commercial & industrial  | \$ 4,334,095                   | \$ -   | \$ 3,192,227           | \$ 1,876,603                      | \$ 73,657                        |  |

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Commercial mortgages:

|                       |           |   |           |           |        |
|-----------------------|-----------|---|-----------|-----------|--------|
| Construction          | 32,266    | - | 32,266    | 8,067     | -      |
| Other                 | 4,148,423 | - | 3,549,686 | 3,374,678 | 63,061 |
| Residential mortgages | 407,105   | - | 408,392   | 309,537   | 21,324 |

With an allowance

recorded:

Commercial, financial and agricultural:

|                         |        |        |        |           |     |
|-------------------------|--------|--------|--------|-----------|-----|
| Commercial & industrial | 23,524 | 23,524 | 23,534 | 1,393,995 | 386 |
| Agricultural            | -      | -      | -      | 6,211     | 453 |

Commercial mortgages:

|              |         |         |         |           |     |
|--------------|---------|---------|---------|-----------|-----|
| Construction | 50,939  | 43,514  | 50,939  | 215,901   | -   |
| Other        | 838,277 | 172,720 | 817,991 | 1,378,687 | 969 |

Residential mortgages - - - 215,299 6,470

Total \$ 9,834,629 \$ 239,758 \$ 8,075,035 \$ 8,778,978 \$ 166,320

The following table presents the recorded investment in non accrual and loans past due over 90 days still on accrual by class of loans:

|   | June 30, 2011 |  | December 31, 2010 |  |
|---|---------------|--|-------------------|--|
|   | Non-Accrual   | Loans Past Due Over 90 Days Still Accruing | Non-Accrual       | Loans Past Due Over 90 Days Still Accruing |
| Commercial, financial and agricultural: |               |  |                   |  |
| Commercial & industrial                 | \$ 7,104,320  | \$ -                                       | \$ 2,938,174      | \$ -                                       |
| Commercial mortgages                    |               | -  | -                 | -  |
| Construction                            | 50,317        | 3,324,639                                  | 83,204            | -  |
| Other                                   | 4,266,152     | -  | 4,230,701         | -  |
| Residential mortgages                   | 2,309,648     | -  | 2,558,534         | -  |
| Consumer loans                          |               |  |                   |  |
| Credit cards                            | -             | 8,608                                      | -                 | 11,174                                     |
| Home equity lines & loans               | 473,953       | -  | 545,039           | -  |
| Indirect consumer loans                 | 166,028       | -  | 180,632           | -  |
| Other direct consumer loans             | 19,712        | -  | 61,601            | -  |
| Total                                   | \$ 14,390,130 | \$ 3,333,247                               | \$ 10,597,886     | \$ 11,174                                  |

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The following tables present the aging of the recorded investment in loans past due (including non-accrual loans) by class of loans as of June 30, 2011 and December 31, 2010 and by loans originated by the Corporation (referred to as "Legacy" Loans) and loans acquired in the FOFC merger (referred to as "Acquired" Loans) which are further discussed in Note 5:

|   | June 30, 2011       |                     |                               |                     |   |                       |                       |
|---|---------------------|---------------------|-------------------------------|---------------------|---|-----------------------|-----------------------|
|   | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due      | Loans Acquired with deteriorated credit quality | Loans Not Past Due    | Total                 |
| Legacy Loans:                           |                     |                     |                               |                     |   |                       |                       |
| Commercial, financial and agricultural: |                     |                     |                               |                     |   |                       |                       |
| Commercial & industrial                 | \$ 10,583           | \$ -                | \$ 2,953,201                  | \$ 2,963,784        | \$ -  | \$ 124,398,708        | \$ 127,362,492        |
| Agricultural                            | -                   | -                   | -                             | -                   | -   | 517,988               | 517,988               |
| Commercial mortgages:                   |                     |                     |                               |                     |   |                       |                       |
| Construction                            | 19,853              | -                   | -                             | 19,853              | -   | 7,687,809             | 7,707,662             |
| Other                                   | 214,514             | -                   | 2,552,134                     | 2,766,648           | -   | 131,023,593           | 133,790,241           |
| Residential mortgages                   | 1,609,372           | 433,019             | 853,400                       | 2,895,791           | -   | 170,822,669           | 173,718,460           |
| Consumer loans:                         |                     |                     |                               |                     |   |                       |                       |
| Credit cards                            | 6,970               | 7,210               | 8,608                         | 22,788              | -   | 1,859,763             | 1,882,551             |
| Home equity lines & loans               | 295,845             | 117,655             | 184,820                       | 598,320             | -   | 75,789,623            | 76,387,943            |
| Indirect consumer loans                 | 357,344             | 54,638              | 144,613                       | 556,595             | -   | 96,455,625            | 97,012,220            |
| Other direct consumer loans             | 35,125              | 6,234               | 3,897                         | 45,256              | -   | 14,257,808            | 14,303,064            |
| <b>Total</b>                            | <b>\$ 2,549,606</b> | <b>\$ 618,756</b>   | <b>\$ 6,700,673</b>           | <b>\$ 9,869,035</b> | <b>\$ -</b>                                     | <b>\$ 622,813,587</b> | <b>\$ 632,682,622</b> |

|   | June 30, 2011       |                     |                               |                |   |                    |               |
|---|---------------------|---------------------|-------------------------------|----------------|---|--------------------|---------------|
|   | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due | Loans Acquired with deteriorated credit quality | Loans Not Past Due | Total         |
| Acquired Loans:                         |                     |                     |                               |                |   |                    |               |
| Commercial, financial and agricultural: |                     |                     |                               |                |   |                    |               |
| Commercial & industrial                 | \$ 37,160           | \$ 119,356          | \$ 352,073                    | \$ 508,589     | \$ 3,313,774                                    | \$ 30,592,681      | \$ 34,415,044 |
| Agricultural                            | -                   | -                   | -                             | -              | -   | -                  | -             |

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|                             |                    |                    |                    |                    |                      |                      |                      |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|----------------------|----------------------|----------------------|
| Commercial mortgages:       |                    |                    |                    |                    |                      |                      |                      |
| Construction                | -                  | 3,517,682          | 3,324,639          | 6,842,321          | 2,517,582            | 16,525,618           | 25,885,521           |
| Other                       | 126,111            | 198,355            | 162,781            | 487,247            | 11,237,159           | 57,577,664           | 69,302,070           |
| Residential mortgages       |                    |                    |                    |                    |                      |                      |                      |
|                             | 1,053,574          | -                  | 141,058            | 1,194,632          | 361,910              | 20,682,094           | 22,238,636           |
| Consumer loans:             |                    |                    |                    |                    |                      |                      |                      |
| Credit cards                | -                  | -                  | -                  | -                  | -                    | -                    | -                    |
| Home equity lines & loans   | -                  | -                  | -                  | -                  | -                    | 6,380,752            | 6,380,752            |
| Indirect consumer loans     | -                  | -                  | -                  | -                  | -                    | -                    | -                    |
| Other direct consumer loans | 4,650              | -                  | -                  | 4,650              | -                    | 171,312              | 175,962              |
| <b>Total</b>                | <b>\$1,221,495</b> | <b>\$3,835,393</b> | <b>\$3,980,551</b> | <b>\$9,037,439</b> | <b>\$ 17,430,425</b> | <b>\$131,930,121</b> | <b>\$158,397,985</b> |



| Legacy Loans:<br>Commercial,<br>financial and<br>agricultural | December 31, 2010      |                           |                                     |                      |                       |                       |
|---|------------------------|---------------------------|-------------------------------------|----------------------|-----------------------|-----------------------|
|   | 30-59 Days<br>Past Due | 60-89<br>Days Past<br>Due | Greater than<br>90 Days<br>Past Due | Total Past<br>Due    | Loans Not Past<br>Due | Total                 |
| Commercial &<br>industrial                                    | \$ 33,434              | \$ 17,351                 | \$ 2,914,640                        | \$ 2,965,425         | \$ 111,202,073        | \$ 114,167,498        |
| Agricultural  | -                      | -                         | -                                   | -                    | 826,501               | 826,501               |
| Commercial<br>mortgages                                       |                        |                           |                                     |                      |                       |                       |
| Construction  | -                      | -                         | 63,102                              | 63,102               | 9,029,450             | 9,092,552             |
| Other   | 116,432                | -                         | 2,913,525                           | 3,029,957            | 121,292,041           | 124,321,998           |
| Residential<br>mortgages                                      | 1,851,412              | 277,276                   | 1,404,067                           | 3,532,755            | 170,341,467           | 173,874,222           |
| Consumer loans  |                        |                           |                                     |                      |                       |                       |
| Credit cards  | 4,889                  | 16,635                    | 11,174                              | 32,698               | 1,989,199             | 2,021,897             |
| Home equity lines<br>& loans                                  | 550,134                | 79,910                    | 321,116                             | 951,160              | 76,052,290            | 77,003,450            |
| Indirect consumer<br>loans                                    | 465,818                | 154,969                   | 146,221                             | 767,008              | 98,571,142            | 99,338,150            |
| Other direct<br>consumer loans                                | 51,125                 | 12,502                    | 41,964                              | 105,591              | 14,629,253            | 14,734,844            |
| <b>Total</b>  | <b>\$ 3,073,244</b>    | <b>\$ 558,643</b>         | <b>\$ 7,815,809</b>                 | <b>\$ 11,447,696</b> | <b>\$ 603,933,416</b> | <b>\$ 615,381,112</b> |

#### Troubled Debt Restructurings:

The Corporation has not allocated any specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of June 30, 2011 or December 31, 2010. The Corporation has not committed to lend any additional amounts as of June 30, 2011 or December 31, 2010 to customers with outstanding loans that are classified as trouble debt restructurings.

#### Credit Quality Indicators:

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes new consumer, mortgage and home equity loans and lines with outstanding balances greater than \$50 thousand, \$250 thousand and \$100 thousand, respectively, along with a sample of existing loans and non-homogeneous loans, such as commercial and commercial real estate loans. The loans meeting these criteria are reviewed at least annually. The Corporation uses the following definitions for risk rating:

Special Mention – Loans classified as special mention have a potential weakness that deserves management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the

loan or the institution's credit position as some future date.

Substandard – Loans classified as substandard are inadequately protected by the current net worth and paying capability of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

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Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. Based on the analysis's performed as of June 30, 2011 and December 31, 2010, the risk category of the recorded investment of loans by class of loans is as follows:

| Legacy Loans:                           | June 30, 2011         |                       |                      |                      |                     |
|---|-----------------------|-----------------------|----------------------|----------------------|---------------------|
|   | Not Rated             | Pass                  | Special<br>Mention   | Substandard          | Doubtful            |
| Commercial, financial and agricultural: |                       |                       |                      |                      |                     |
| Commercial & industrial                 | \$ -                  | \$ 104,337,788        | \$ 10,799,719        | \$ 10,662,192        | \$ 1,562,794        |
| Agricultural                            | -                     | 517,863               | 125                  | -                    | -                   |
| Commercial mortgages:                   |                       |                       |                      |                      |                     |
| Construction                            | -                     | 6,214,757             | 638,046              | 515,450              | 339,408             |
| Other                                   | -                     | 118,281,674           | 7,128,938            | 8,379,629            | -                   |
| Residential mortgages                   | 171,340,299           | -                     | -                    | 2,378,161            | -                   |
| Consumer loans:                         |                       |                       |                      |                      |                     |
| Credit cards                            | 1,882,551             | -                     | -                    | -                    | -                   |
| Home equity lines & loans               | 75,913,990            | -                     | -                    | 473,953              | -                   |
| Indirect consumer loans                 | 96,839,047            | -                     | -                    | 173,173              | -                   |
| Other direct consumer loans             | 14,283,353            | -                     | -                    | 19,712               | -                   |
| <b>Total</b>                            | <b>\$ 360,259,240</b> | <b>\$ 229,352,082</b> | <b>\$ 18,566,828</b> | <b>\$ 22,602,270</b> | <b>\$ 1,902,202</b> |

|   |                      |                       |                   |                     |             |
|---|----------------------|-----------------------|-------------------|---------------------|-------------|
| Acquired Loans:                         |                      |                       |                   |                     |             |
| Commercial, financial and agricultural: |                      |                       |                   |                     |             |
| Commercial & industrial                 | \$ -                 | \$ 30,776,530         | \$ -              | \$ 324,741          | \$ -        |
| Agricultural                            | -                    | -                     | -                 | -                   | -           |
| Commercial mortgages:                   |                      |                       |                   |                     |             |
| Construction                            | -                    | 22,090,680            | -                 | 1,277,258           | -           |
| Other                                   | -                    | 55,779,527            | 640,783           | 1,644,601           | -           |
| Residential mortgages                   | 21,735,667           | -                     | -                 | 141,059             | -           |
| Consumer loans:                         |                      |                       |                   |                     |             |
| Credit cards                            | -                    | -                     | -                 | -                   | -           |
| Home equity lines & loans               | 6,380,752            | -                     | -                 | -                   | -           |
| Indirect consumer loans                 | -                    | -                     | -                 | -                   | -           |
| Other direct consumer loans             | 175,962              | -                     | -                 | -                   | -           |
| <b>Total</b>                            | <b>\$ 28,292,381</b> | <b>\$ 108,646,737</b> | <b>\$ 640,783</b> | <b>\$ 3,387,659</b> | <b>\$ -</b> |

| Legacy Loans: | December 31, 2010 |      |                    |             |          |
|---------------|-------------------|------|--------------------|-------------|----------|
|               | Not Rated         | Pass | Special<br>Mention | Substandard | Doubtful |

Commercial, financial  
and agricultural:

|                                |    |             |                |               |               |              |
|--------------------------------|----|-------------|----------------|---------------|---------------|--------------|
| Commercial &<br>industrial     | \$ | -           | \$ 90,887,538  | \$ 16,946,891 | \$ 4,770,276  | \$ 1,562,794 |
| Agricultural                   |    | -           | 824,882        | 1,619         | -             | -            |
| Commercial mortgages:          |    |             |                |               |               |              |
| Construction                   |    | -           | 7,497,488      | 672,136       | 922,928       | -            |
| Other                          |    | -           | 108,732,393    | 7,245,641     | 8,343,964     | -            |
| Residential mortgages          |    | 171,024,544 | -              | -             | 2,849,678     | -            |
| Consumer loans:                |    |             |                |               |               |              |
| Credit cards                   |    | 2,021,896   | -              | -             | -             | -            |
| Home equity lines &<br>loans   |    | 76,458,414  | -              | -             | 545,037       | -            |
| Indirect consumer<br>loans     |    | 99,155,306  | -              | -             | 77,883        | -            |
| Other direct consumer<br>loans |    | 14,656,690  | -              | -             | 182,844       | -            |
| Total                          | \$ | 363,317,120 | \$ 207,942,301 | \$ 24,866,287 | \$ 17,692,610 | \$ 1,562,794 |

The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity as of June 30, 2011 and December 31, 2010:

| Legacy Loans:   | June 30, 2011            |              |                              |                               |                                   |
|-----------------|--------------------------|--------------|------------------------------|-------------------------------|-----------------------------------|
|                 | Consumer Loans           |              |                              |                               |                                   |
|                 | Residential<br>Mortgages | Credit Card  | Home Equity<br>Lines & Loans | Indirect<br>Consumer<br>Loans | Other Direct<br>Consumer<br>Loans |
| Performing      | \$ 171,261,066           | \$ 1,873,942 | \$ 75,913,990                | \$ 96,846,193                 | \$ 14,283,353                     |
| Non-Performing  | 2,457,394                | 8,608        | 473,953                      | 166,028                       | 19,712                            |
| Total           | \$ 173,718,460           | \$ 1,882,550 | \$ 76,387,943                | \$ 97,012,221                 | \$ 14,303,065                     |
| Acquired Loans: |                          |              |                              |                               |                                   |
| Performing      | \$ 22,097,577            | \$ -         | \$ 6,380,752                 | \$ -                          | \$ 175,962                        |
| Non-Performing  | 141,059                  | -            | -                            | -                             | -                                 |
| Total           | \$ 22,238,636            | \$ -         | \$ 6,380,752                 | \$ -                          | \$ 175,962                        |

| Legacy Loans:  | December 31, 2010        |              |                              |                               |                                   |
|----------------|--------------------------|--------------|------------------------------|-------------------------------|-----------------------------------|
|                | Consumer Loans           |              |                              |                               |                                   |
|                | Residential<br>Mortgages | Credit Card  | Home Equity<br>Lines & Loans | Indirect<br>Consumer<br>Loans | Other Direct<br>Consumer<br>Loans |
| Performing     | \$ 171,070,881           | \$ 2,010,723 | \$ 76,458,413                | \$ 99,157,518                 | \$ 14,673,243                     |
| Non-Performing | 2,803,342                | 11,174       | 545,037                      | 186,632                       | 61,601                            |
| Total          | \$ 173,874,223           | \$ 2,021,897 | \$ 77,003,450                | \$ 99,338,150                 | \$ 14,734,844                     |

## 10. Components of Quarterly and Year-to-Date Net Periodic Benefit Costs

|   | Six Months Ended June 30, |             | Three Months Ended June 30, |            |
|---|---------------------------|-------------|-----------------------------|------------|
|   | 2011                      | 2010        | 2011                        | 2010       |
| <b>Qualified Pension</b>                              |                           |             |                             |            |
| Service cost, benefits earned during the period       | \$ 518,268                | \$ 532,716  | \$ 259,134                  | \$ 266,358 |
| Interest cost on projected benefit obligation         | 785,912                   | 958,024     | 392,956                     | 479,012    |
| Expected return on plan assets                        | (1,171,346)               | (1,388,272) | (585,673 )                  | (694,136)  |
| Amortization of unrecognized transition obligation    | -                         | -           | -                           | -          |
| Amortization of unrecognized prior service cost       | 14,940                    | 28,396      | 7,470                       | 14,198     |
| Amortization of unrecognized net loss                 | 338,226                   | 369,136     | 169,113                     | 184,568    |
| Net periodic pension expense                          | \$ 486,000                | \$ 500,000  | \$ 243,000                  | \$ 250,000 |
| <b>Supplemental Pension</b>                           |                           |             |                             |            |
| Service cost, benefits earned during the period       | \$ 15,312                 | \$ 16,514   | 7,656                       | \$ 8,257   |
| Interest cost on projected benefit obligation         | 26,887                    | 30,424      | 13,443                      | 15,212     |
| Expected return on plan assets                        | -                         | -           | -                           | -          |
| Amortization of unrecognized prior service cost       | -                         | -           | -                           | -          |
| Amortization of unrecognized net loss                 | 4,732                     | 3,062       | 2,366                       | 1,531      |
| Net periodic supplemental pension expense             | \$ 46,931                 | \$ 50,000   | \$ 23,465                   | \$ 25,000  |
| <b>Postretirement, Medical and Life</b>               |                           |             |                             |            |
| Service cost, benefits earned during the period       | \$ 16,500                 | \$ 15,000   | 8,250                       | \$ 7,500   |
| Interest cost on projected benefit obligation         | 37,500                    | 37,500      | 18,750                      | 18,750     |
| Expected return on plan assets                        | -                         | -           | -                           | -          |
| Amortization of unrecognized prior service cost       | (48,500 )                 | (47,500)    | (24,250 )                   | (23,750)   |
| Amortization of unrecognized net gain                 | -                         | -           | -                           | -          |
| Net periodic postretirement, medical and life expense | \$ 5,500                  | \$ 5,000    | \$ 2,750                    | \$ 2,500   |

On April 21, 2010 the Corporation's Board of Directors approved an amendment to the Corporation's Defined Benefit Pension Plan. Under the amendment, which became effective on July 1, 2010, new employees hired on or after the effective date will not be eligible to participate in the plan, however, existing participants at that time will continue to accrue benefits. The Corporation anticipates that the amendment will result in a decrease in the future benefit obligations of the plan and the corresponding net periodic benefit cost associated with the plan.



## 11. Segment Reporting

The Corporation manages its operations through two primary business segments: core banking and trust and investment advisory services. The core banking segment provides revenues by attracting deposits from the general public and using such funds to originate consumer, commercial, commercial real estate, and residential mortgage loans, primarily in the Corporation's local markets and to invest in securities. The trust and investment advisory services segment provides revenues by providing trust and investment advisory services to clients.

Summarized financial information concerning the Corporation's reportable segments and the reconciliation to the Corporation's consolidated results is shown in the following table. Income taxes are allocated based on the separate taxable income of each entity and indirect overhead expenses are allocated based on reasonable and equitable allocations applicable to the reportable segment. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the Holding Company and Other column below, along with amounts to eliminate transactions between segments. (dollars in thousands)

|   | Three Months Ended June 30, 2011 |                                      |                           |                     | Six Months Ended June 30, 2011 |                                      |                           |                     |
|---|----------------------------------|--------------------------------------|---------------------------|---------------------|--------------------------------|--------------------------------------|---------------------------|---------------------|
|   | Core Banking                     | Trust & Investment Advisory Services | Holding Company And Other | Consolidated Totals | Core Banking                   | Trust & Investment Advisory Services | Holding Company And Other | Consolidated Totals |
| Net interest income                                 | \$ 11,448                        | \$ -                                 | \$ 3                      | \$ 11,451           | \$ 19,992                      | \$ -                                 | \$ 5                      | \$ 19,997           |
| Provision for loan losses                           | 125                              | -                                    | -                         | 125                 | 250                            | -                                    | -                         | 250                 |
| Net interest income after provision for loan losses | 11,323                           | -                                    | 3                         | 11,326              | 19,742                         | -                                    | 5                         | 19,747              |
| Other operating income                              | 2,732                            | 1,768                                | 244                       | 4,744               | 4,819                          | 3,384                                | 888                       | 9,091               |
| Other operating expenses                            | 10,215                           | 1,791                                | 195                       | 12,201              | 18,620                         | 3,607                                | 417                       | 22,644              |
| Income before income tax expense                    | 3,840                            | (23)                                 | 52                        | 3,869               | 5,941                          | (223)                                | 476                       | 6,194               |
| Income tax expense                                  | 1,255                            | (9)                                  | 3                         | 1,249               | 1,846                          | (86)                                 | 149                       | 1,909               |
| Segment net income                                  | \$ 2,585                         | \$ (14)                              | \$ 49                     | \$ 2,620            | \$ 4,095                       | \$ (137)                             | \$ 327                    | \$ 4,285            |
| Segment assets                                      |                                  |                                      |                           |                     | \$ 1,228,705                   | \$ 6,020                             | \$ 2,311                  | \$ 1,237,036        |

|  | Three Months Ended June 30, 2010 |                                      |                           |                     | Six Months Ended June 30, 2010 |                                      |                           |                     |
|--|----------------------------------|--------------------------------------|---------------------------|---------------------|--------------------------------|--------------------------------------|---------------------------|---------------------|
|  | Core Banking                     | Trust & Investment Advisory Services | Holding Company And Other | Consolidated Totals | Core Banking                   | Trust & Investment Advisory Services | Holding Company And Other | Consolidated Totals |



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|   |          |        |      |          |            |          |          |              |
|---|----------|--------|------|----------|------------|----------|----------|--------------|
| Net interest income                                 | \$ 8,778 | \$ -   | \$ 1 | \$ 8,779 | \$ 17,289  | \$ -     | \$ 2     | \$ 17,291    |
| Provision for loan losses                           | 375      | -      | -    | 375      | 750        | -        | -        | 750          |
| Net interest income after provision for loan losses | 8,403    | -      | 1    | 8,404    | 16,539     | -        | 2        | 16,541       |
| Other operating income                              | 2,519    | 1,985  | 161  | 4,665    | 4,290      | 4,073    | 297      | 8,660        |
| Other operating expenses                            | 7,488    | 1,751  | 176  | 9,415    | 14,681     | 3,599    | 381      | 18,661       |
| Income before income tax expense                    | 3,434    | 234    | (14) | 3,654    | 6,148      | 474      | (82)     | 6,540        |
| Income tax expense                                  | 1,082    | 90     | (21) | 1,151    | 1,920      | 183      | (66)     | 2,037        |
| Segment net income                                  | \$ 2,352 | \$ 144 | \$ 7 | \$ 2,503 | \$ 4,228   | \$ 291   | \$ (16)  | \$ 4,503     |
| Segment assets                                      |          |        |      |          | \$ 991,219 | \$ 6,690 | \$ 3,071 | \$ 1,000,980 |

## 12. Stock Based Compensation

## Board of Director's Stock Compensation

Members of the Board of Directors receive common shares of the Corporation equal in value to the amount of fees individually earned during the previous year for service as a director. The common shares are distributed to the Corporation's individual board members from treasury shares of the Corporation on or about January 15 following the calendar year of service.

Additionally, the President and CEO of the Corporation, who does not receive cash compensation as a member of the Board of Directors, is awarded common shares equal in value to the average of those awarded to board members not employed by the Corporation who have served for twelve (12) months during the prior year.

An expense of \$231 thousand related to this compensation was recognized during the year of 2010. During January 2011, 10,378 shares were re-issued from treasury to fund the stock component of directors' compensation.

## Restricted Stock Plan

On June 16, 2010, the Corporation's Board of Directors approved the Corporation's Restricted Stock Plan (the "Plan"), which became effective immediately. Pursuant to the Plan, the Corporation may make discretionary grants of restricted stock to officers other than the Corporation's Chief Executive Officer. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at issue date. The maximum number of shares as to which stock awards may be granted under the Plan is 10,000 per year, with these shares vesting over a 5 year period.

A summary of restricted stock activity from December 31, 2010 to June 30, 2011 is presented below:

|                                   | Shares | Weighted-Average<br>Grant Date Fair<br>Value |
|-----------------------------------|--------|--|
| Nonvested at<br>December 31, 2010 | 5,886  | \$ 21.25                                     |
| Granted                           | 1,087  | 23.00  |
| Vested                            | -      | -  |
| Forfeited or<br>Cancelled         | -      | -  |
| Nonvested at June 30,<br>2011     | 6,973  | \$ 21.52                                     |

As of June 30, 2011, there was \$136,275 of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 4.67 years.



Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

The review that follows focuses on the significant factors affecting the financial condition and results of operations of the Corporation during the three and six-month periods ended June 30, 2011, with comparisons to the comparable periods in 2010, as applicable. The following discussion and the unaudited consolidated interim financial statements and related notes included in this report should be read in conjunction with our 2010 Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 16, 2011. The results for the periods presented are not necessarily indicative of results to be expected for the entire fiscal year or any other interim period.

Forward-looking Statements

This discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The Corporation intends its forward-looking statements to be covered by the safe harbor provisions for forward-looking statements in these sections. All statements regarding the Corporation's expected financial position and operating results, the Corporation's business strategy, the Corporation's financial plans, forecasted demographic and economic trends relating to the Corporation's industry and similar matters are forward-looking statements. These statements can sometimes be identified by the Corporation's use of forward-looking words such as "may," "will," "anticipate," "estimate," "expect," or "intend." The Corporation cannot promise that its expectations in such forward-looking statements will turn out to be correct. The Corporation's actual results could be materially different from expectations because of various factors, including changes in economic conditions or interest rates, credit risk, difficulties in managing our growth, including those in connection with our April 8, 2011 acquisition of Fort Orange Financial Corporation and the integration of its business with ours, competition, changes in law or the regulatory environment, including the Dodd-Frank Wall Street Reform and Consumer Protection Act, and changes in general business and economic trends. Information concerning risks facing the Corporation can be found in our periodic filings with the Securities and Exchange Commission, including in our 2010 Annual Report on Form 10-K. These filings are available publicly on the SEC's website at <http://www.sec.gov>, on the Corporation's website at <http://www.chemungcanal.com> or upon request from the Corporate Secretary at (607) 737-3788. Except as otherwise required by law, the Corporation undertakes no obligation to publicly update or revise its forward-looking statements, whether as a result of new information, future events or otherwise.

Critical Accounting Policies, Estimates and Risks and Uncertainties

Critical accounting policies include the areas where the Corporation has made what it considers to be particularly difficult, subjective or complex judgments concerning estimates, and where these estimates can significantly affect the Corporation's financial results under different assumptions and conditions. The Corporation prepares its financial statements in conformity with accounting principles generally accepted in the United States of America. As a result, the Corporation is required to make certain estimates, judgments and assumptions that it believes are reasonable based upon the information available at that time. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods presented. Actual results could be different from these estimates.

Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the uncertainty in evaluating the level of the allowance required to cover probable incurred credit losses inherent in the loan portfolio, and the material effect that such judgments can have on the Corporation's results of operations. While management's current evaluation of the allowance for loan losses indicates that the allowance is adequate, under adversely different conditions or assumptions the allowance would need to be increased. For example, if historical loan loss experience significantly worsened or if current economic conditions significantly deteriorated, additional provisions for loan losses would be required to increase the allowance. In addition, the assumptions and estimates used in the internal reviews of the Corporation's non-performing loans and potential problem loans, and the associated evaluation of the related collateral coverage for these loans, has a significant impact on the overall analysis of the adequacy of the allowance for loan losses. Real estate values in the Corporation's market area did not increase dramatically in the prior several years, and, as a result, any declines in real estate values have been modest. While management has concluded that the current evaluation of collateral values is reasonable under the circumstances, if collateral evaluations were significantly lowered, the Corporation's allowance for loan losses policy would also require additional provisions for loan losses.

Management also considers the accounting policy relating to other-than-temporary impairment ("OTTI") of investment securities to be a critical accounting policy. The determination of whether a decline in market value is other-than-temporary is necessarily a matter of subjective judgment. The timing and amount of any realized losses reported in the Corporation's financial statements could vary if management's conclusions were to change as to whether an other-than-temporary impairment exists. The Corporation assesses whether it intends to sell, or it is more likely than not that it will be required to sell a security in an unrealized loss position before recovery of its amortized cost basis. If either of these criteria is met, the entire difference between amortized cost and fair value is recognized through a charge to earnings. For those securities that do not meet the aforementioned criteria, such as those that management has determined to be other-than-temporarily impaired, the amount of impairment charged to earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income. Our analysis of these investments includes \$723 thousand book value of two collateralized debt obligations ("CDO's") consisting of pooled trust preferred securities. These securities were rated high quality when purchased, but at June 30, 2011 Moody's rated these securities both as Caa3, which is defined as substantial risk of default. The Corporation uses an OTTI evaluation model to compare the present value of expected cash flows to the previous estimate to determine if there are adverse changes in cash flows during the quarter. The OTTI model considers the structure and term of the CDO and the financial condition of the underlying issuers. Specifically, the model details interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. Assumptions used in the model include expected future default rates and prepayments. We assume no recoveries on defaults and treat all interest payment deferrals as defaults. Additional default assumptions were made based on credit quality ratios and performance measures of the remaining financial institutions in the pools, as well as overall default rates based on historical bank debt default rate averages. For the three and six-month periods ended June 30, 2011, no OTTI losses were recognized in earnings. Both of these securities remained classified as available for sale and represented \$351 thousand of the unrealized losses reported at June 30, 2011. One of the securities continues to accrue interest and payments continue to be made as agreed, however the Corporation learned in early August 2011 that the other security was officially in default and the quarterly interest payment would not be made as scheduled. This action had no material impact to the financial statements as of June 30, 2011 and no further interest will be accrued on this security.

Management also considers the accounting policy relating to the valuation of goodwill and other intangible assets to be a critical accounting policy. The initial carrying value of goodwill and other intangible assets is determined using estimated fair values developed from various sources and other generally accepted valuation techniques. Estimates are based upon financial, economic, market and other conditions as they existed as of the date of a particular acquisition. These estimates of fair value are the results of judgments made by the Corporation based upon estimates that are inherently uncertain and changes in the assumptions upon which the estimates were based may have a significant impact on the resulting estimates. In addition to the initial determination of the carrying value, on an ongoing basis management must assess whether there is any impairment of goodwill and other intangible assets that would require an adjustment in carrying value and recognition of a loss in the consolidated statement of income.

### Financial Condition

Consolidated assets at June 30, 2011 totaled \$1.237 billion, an increase of \$278.7 million or 29.1% since December 31, 2010. As discussed in greater detail below, this increase was due in large part to the Corporation's acquisition of Fort Orange Financial Corp. ("FOFC") and the concurrent merger of its banking subsidiary, Capital Bank & Trust Company ("Capital Bank") into the Bank on April 8, 2011, as well as other organic growth. The increase was reflected principally in a \$175.0 million increase in loans, net of deferred fees and costs and unearned income, a \$60.9 million increase in the securities portfolio, a \$23.3 million increase in cash and cash equivalents and increases in goodwill and other intangible assets totaling \$12.7 million and \$2.1 million, respectively, as well as a \$3.4 million increase in other assets.

As noted above, total loans, net of deferred fees and costs and unearned income increased \$175.0 million or 28.5% from December 31, 2010 to June 30, 2011, principally due to the acquisition of Capital Bank loans totaling \$165.9 million at quarter-end. The most significant growth was in commercial loans (including commercial mortgages), which increased \$150.1 million, with \$137.1 million of this increase associated with the Capital Bank acquisition. Residential mortgages increased \$21.7 million, including Capital Bank mortgages totaling \$22.3 million at June 30, 2011. Total consumer loans were up \$3.2 million, principally due to a \$5.9 million increase in home equity balances, as home equity loans associated with the acquisition totaled \$6.3 million at June 30, 2011. This increase was offset primarily by a \$2.2 million decrease in indirect consumer installment loans and a \$269 thousand decrease in other consumer installment loans. During the first six months of this year, approximately \$3.4 million of newly originated residential mortgages were sold in the secondary market to Freddie Mac, with an additional \$280 thousand originated and sold to the State of New York Mortgage Agency.

The composition of the loan portfolio is summarized as follows:

|  | June 30, 2011  | December 31, 2010 |
|--|----------------|-------------------|
| Commercial, financial and agricultural   | \$ 159,906,838 | \$ 114,697,440    |
| Commercial mortgages   | 238,003,579    | 133,070,484       |
| Residential mortgages  | 195,150,301    | 173,467,806       |
| Indirect Consumer loans  | 96,699,376     | 98,940,854        |
| Consumer loans   | 98,959,933     | 93,507,785        |
| Total loans, net of deferred origination fees and cost,<br>and unearned income | \$ 788,720,027 | \$ 613,684,369    |



The available for sale segment of the securities portfolio totaled \$284.1 million at June 30, 2011, an increase of approximately \$60.6 million or 27.1% from December 31, 2010. At amortized cost, the available for sale portfolio increased \$56.1 million, including approximately \$44.1 million of bonds related to the Capital Bank acquisition. Unrealized appreciation related to the available for sale portfolio increased \$4.5 million since year-end 2010. A \$34.1 million increase in federal agency bonds includes \$13.2 million of balances related to the acquisition. Additionally, during the first six months of this year, other purchases of agency bonds totaling \$46.5 million were offset by calls and maturities totaling approximately \$25.6 million. A \$9.0 million increase in available for sale municipal bonds include Capital Bank bond balances totaling \$6.2 million at June 30, 2011. Increases in collateralized mortgage obligations, corporate bonds and SBA guaranteed loan pools totaling \$9.0 million, \$3.0 million and \$2.3 million, respectively, were all related to the Capital Bank acquisition. Additionally, a \$234 thousand increase in U.S. Treasury bonds reflects purchases during the first six months of this year totaling \$30.3 million, offset by sales totaling \$30.0 million. These increases were somewhat offset by a \$1.6 million decrease in mortgage-backed securities as a \$10.4 million increase resulting from the FOFC acquisition was offset by paydowns on other mortgage-backed securities. The increase in unrealized appreciation related to the available for sale portfolio was due in large part to the impact of lower mid-to long-term rates on the various bond portfolios as well as an increase in unrealized gains in the Corporation's equity portfolio. The held to maturity portion of the portfolio, consisting of local municipal obligations, increased approximately \$326 thousand from \$7.7 million at December 31, 2010 to \$8.0 million at June 30, 2011.

As noted above, total cash and cash equivalents increased \$23.3 million since December 31, 2010. Due in large part to net cash received in the FOFC acquisition, interest bearing deposits at other financial institutions increased \$12.1 million. Additionally, cash and due from financial institutions increased \$11.2 million primarily due to an increased level of federal transit items and period-end branch cash levels. With total cash and due from banks totaling \$83.9 million at June 30, 2011, the Corporation continues to maintain a strong liquidity position and we continue to evaluate alternative investment of these funds with caution given the low interest rate environment and the inherent interest rate risk associated with longer term securities portfolio investments.

The \$12.7 million increase in goodwill as well as the \$2.1 million increase in other intangible assets was directly related to the FOFC acquisition. The \$2.1 million increase, net of amortization in other intangible assets includes \$2.5 million in other intangibles associated with this acquisition, which the Corporation is amortizing on an accelerated basis over a 10 year period.

A \$3.4 million increase in other assets was due principally to a \$1.2 million increase in accrued interest receivable due in large part to the FOFC acquisition, a \$470 thousand increase in net deferred tax assets, a \$495 thousand increase in prepaid taxes and a \$687 thousand estimated income tax receivable related to the FOFC acquisition. Additionally, prepaid FDIC insurance premiums increased \$324 thousand as a result of the acquisition.



Since December 31, 2010, total deposits have increased \$227.6 million or 28.9% to \$1.014 billion, with \$183.3 million of this increase attributed to the FOFC acquisition, and \$44.3 million due to organic deposit growth. Non-interest bearing demand deposits increased \$48.0 million, including balances at the Capital Bank offices acquired of \$25.4 million. A \$179.6 million increase in interest bearing balances was due principally to increases in savings and time deposit balances of \$74.2 million and \$64.1 million, respectively, as well as a \$31.0 million increase in NOW accounts and a \$10.4 million increase in insured money market account (“IMMA”) balances. The \$74.2 million increase in savings balances includes \$60.1 million related to the FOFC acquisition as well as increases in public fund and other balances totaling \$4.3 million and \$9.8 million, respectively, while the \$64.1 million increase in time deposits includes \$63.1 million of Capital Bank deposits and a \$12.2 million increase in public fund balances, partially offset by decreases in other personal and non-personal balances. The \$31.0 million increase in NOW accounts was principally due to Capital Bank balances totaling \$26.2 million as well as a \$6.7 million increase in public funds, while the \$10.4 million increase in IMMA balances includes \$8.4 million in Capital Bank deposits and a \$3.9 million increase in public fund balances.

A \$24.1 million increase in long term borrowings was due to the Corporation assuming the term debt of Capital Bank.

The \$29.2 million increase in total shareholders equity was due in large part to the issuance of 1,009,942 shares to acquire shares of former FOFC shareholders, which resulted in an increase in common stock and additional paid-in-capital totaling \$23.7 million. Other significant increases included a \$3.0 million increase in accumulated other comprehensive income and a \$2.3 million increase in retained earnings.

#### Asset Quality

##### Non-Performing Loans

Non-performing loans at June 30, 2011 totaled \$17.934 million compared to \$11.254 million at year-end 2010, an increase \$6.680 million. Not included in the non-performing loan totals are loans acquired in the FOFC acquisition which the Corporation has identified as purchased credit impaired (“PCI”) loans and which are accounted for under separate accounting guidance, Accounting Standards Codification (“ASC”) Subtopic 310-30, “Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality”. The increase in non-performing loans was due to increases in non-accrual loans and loans 90 days or more past due totaling \$3.743 million and \$3.308 million, respectively, partially offset by a \$371 thousand decrease in troubled debt restructurings (“TDRs”). The \$3.743 million increase in non-accrual loans was due to a \$4.145 million increase in non-accruing commercial loans that was primarily due to the addition to non-accrual status of loans to one borrower totaling \$3.790 million. Other commercial loan additions to non-accrual status since year-end 2010 totaled \$674 thousand. These increases were offset in part by principal reductions on other non-accrual commercial loans. The increase in non-accrual commercial loans was partially offset by decreases in non-accrual residential mortgages, home equity and other consumer loans totaling, \$270 thousand, \$72 thousand and \$59 thousand, respectively. Included in the non-accrual loan totals are commercial loans to one borrower totaling \$5.192 million which carry guarantees of the United States Department of Agriculture (“USDA”) totaling \$4.847 million, thereby reducing the Corporation's remaining exposure on these loans to \$345 thousand. It is generally the Corporation's policy that a loan 90 days past due be placed in non-accrual status unless factors exist that would eliminate the need to place a loan in this status. A loan may also be designated as non-accrual at any time if payment of principal or interest in full is not expected due to deterioration in the financial condition of the borrower. Loans remain in non-accrual status until the loans have been brought current and remain current for a period of six months. In the case of non-accrual loans where a portion of the loan has been charged off, the remaining balance is kept in non-accrual status until the entire principal balance has been recovered.



Accruing loans 90 days or more past due totaled \$3.319 million at June 30, 2011 compared to \$11 thousand at year-end 2010, an increase of \$3.308 million. This increase was due to loans not considered by management to be PCI loans acquired in the FOFC acquisition, including \$3.223 million of construction loans that for a variety of reasons are 90 days or more past their stated maturity dates, however the borrowers continue to make required interest payments. Additionally, these loans carry third party credit enhancements, and based upon the strength of those credit enhancements, the Corporation has not identified these loans as PCI loans and expects to incur no losses on these loans.

As noted above, accruing TDRs decreased \$371 thousand since December 31, 2010 as during the first quarter a commercial loan totaling \$136 thousand and two residential mortgages totaling \$94 thousand at December 31, 2010 were removed from TDR status in accordance with the Corporation's policy that TDRs that have continued to be in compliance with modified terms and conditions for six months and yield a market rate at the time of restructuring not be reported as TDRs in years subsequent to the year in which the loan was first reported as TDR. Additionally, \$139 thousand of principal reductions have been received on a commercial loan TDR. Concessions made on commercial loan TDRs involve short term deferrals of principal payments, while residential mortgage restructurings include interest rate and/or payment reductions. Overall, our past experience in working with borrowers in restructuring troubled debt has been favorable. TDRs are evaluated for impairment based upon the present value of expected future cash flows with any changes recorded through the provision for loan losses.

At June 30, 2011, OREO totaled \$430 thousand compared to \$741 thousand at December 31, 2010, a decrease of \$311 thousand. During the first six months of this year one property totaling \$33 thousand was placed in OREO and two properties totaling \$236 thousand were sold. The balance of the decrease was due to the receipt of private mortgage insurance reimbursement on one property. At June 30, 2011, OREO properties consisted of three residential properties totaling \$118 thousand, two commercial properties totaling \$94 thousand and undeveloped land totaling \$218 thousand.

#### Impaired Loans

Impaired loans, excluding residential real estate loans determined to be troubled debt restructurings, at June 30, 2011 totaled \$11.539 million compared to \$7.665 million at December 31, 2010. Not included in the impaired loan totals are loans acquired in the FOFC acquisition which the Corporation has identified as PCI loans as these loans are accounted for under ASC Subtopic 310-30 as noted under the above discussion of non-performing loans. The increase of \$3.874 million resulted principally from the above discussed increase in non-accrual commercial loans. Included in the impaired loan total are loans totaling \$4.415 million for which impairment allowances of \$884 thousand have been specifically allocated to the allowance for loan losses. As of December 31, 2010, the impaired loan total included \$892 thousand of loans for which specific impairment allowances of \$240 thousand were allocated to the allowance for loan losses. The increases in both the amount of impaired loans for which specific allowances were allocated to the allowance for loan losses and the amount allocated were both primarily due to the above mentioned addition to non-accrual loans of loans to one borrower totaling \$3.790 million. The majority of the Corporation's impaired loans are secured and measured for impairment based on collateral evaluations. It is the Corporation's policy to obtain updated appraisals on loans secured by real estate at the time a loan is determined to be impaired. Prior to the receipt of the updated appraisal, an impairment measurement is performed based upon the most recent appraisal on file to determine the amount of any specific allocation or charge-off. Upon receipt and review of the updated appraisal, an additional measurement is performed to determine if any adjustments are necessary to reflect the proper provisioning or charge-off. Impaired loans are reviewed on a quarterly basis to determine if any changes in credit quality or market conditions would require any additional allocation or recognition of additional charge-offs. If market conditions warrant, future appraisals are obtained. Real estate values in the Corporation's market area had not increased dramatically in the prior several years, and, as a result, declines in real estate values have been modest.



The appraisals are performed by independent third parties and reflect the properties market value "as is". In determining the amount of any specific allocation or charge-off, the Corporation will make adjustments to reflect the estimated costs to sell the property. In situations where partial charge-offs have been recognized, any balance remaining continues to be reflected as non-performing until the loan has been paid in full. In the case of impaired loans secured by assets other than real estate (i.e. business assets), a collateral valuation is performed using data from the client's most recently received financial statements, and applying discount rates based upon the type of collateral.

The following table summarizes the Corporation's non-performing assets:

| (dollars in thousands)                  | June 30, 2011 | December 31, 2010 |
|---|---------------|-------------------|
| Non-accrual loans                       | \$ 14,329     | \$ 10,586         |
| Troubled debt restructurings            | 286           | 657               |
| Accruing loans past due 90 days or more | 3,319         | 11                |
| Total non-performing loans              | \$ 17,934     | \$ 11,254         |
| Other real estate owned                 | 430           | 741               |
| Total non-performing assets             | \$ 18,364     | \$ 11,995         |

In addition to non-performing loans, as of June 30, 2011, the Corporation has identified commercial relationships totaling \$11.4 million as potential problem loans, as compared to \$7.2 million at December 31, 2010. This increase of \$4.2 million resulted from the addition of a commercial relationship totaling \$2.6 million during the first quarter of this year, as well as the addition of \$1.8 million of loans acquired in the FOFC acquisition which were not considered to be PCI loans, partially offset by principal reductions on other potential problem loans. Potential problem loans are loans that are currently performing, but known information about possible credit problems of the related borrowers causes management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms, which may result in the disclosure of such loans as non-performing at some time in the future. Potential problem loans are typically loans that are performing but are classified in the Corporation's loan rating system as "substandard." Management cannot predict the extent to which economic conditions may worsen or other factors which may impact borrowers and the potential problem loans. Accordingly, there can be no assurance that other loans will not become 90 days or more past due, be placed on non-accrual, be restructured, or require increased allowance coverage and provisions for loan losses.

Management's evaluation of the adequacy of the allowance for loan losses is performed on a periodic basis and takes into consideration such factors as historical loan loss experience, review of specific problem loans (including evaluation of the underlying collateral) changes in the composition and volume of the loan portfolio, recent charge-off experience, overall portfolio quality and current economic conditions that may affect the borrowers' ability to pay.

While impaired loans increased \$3.874 million since year-end 2010, this increase, as noted above, was principally due to the addition of a commercial relationship totaling \$3.790 million which resulted in a \$644 thousand increase in specific allowances allocated against impaired loans. With the exception of this one relationship, overall credit quality has remained stable and we continue to see signs of improvement as evidenced by significant reductions in net charge-offs as discussed below. Based upon an analysis of the factors mentioned above, the Corporation's provision for loan losses for the second quarter of this year totaled \$125 thousand compared to \$375 thousand for the second quarter of 2010, with the year-to-date provision of \$250 thousand down \$500 thousand when compared to last year.

Net charge-offs for the first six months of this year as compared to 2010 improved by \$278 thousand from \$270 thousand in net charge-offs during the first six months of last year to net recoveries of \$8 thousand this year. This improvement was principally due to decreases in net consumer loan and residential mortgage charge-offs totaling \$166 thousand and \$66 thousand, respectively, as well as a \$46 thousand increase in net commercial loan recoveries. At June 30, 2011, the Corporation's allowance for loan losses totaled \$9.756 million, resulting in a coverage ratio of allowance to non-performing loans of 54.4%. As noted above, included in non-performing loans at June 30, 2011 were loans which carried USDA guarantees totaling \$4.847 million. Also included in the non-performing loan totals are other loans with remaining balances totaling \$375 thousand on which the Corporation has previously recognized partial charge-offs in the amount of \$772 thousand. Excluding the USDA guaranteed amount and other loans for which partial charge-offs have already been recognized from the non-performing total, the coverage ratio of allowance to non-performing loans was 76.7%. This ratio as well as the ratio of allowance to total loans was also impacted by the Capital Bank acquisition, as current accounting rules do not allow the acquirer to transfer the acquiree's allowance for loan losses to the acquirer's balance sheet. Rather, the acquiree's overall loan quality is a component in determining the fair value of loans acquired, which are carried on the balance sheet at fair value. Excluding acquired loans reported above as non-performing loans totaling \$3.825 million, as well as the aforementioned USDA guarantee and loans for which partial charge-offs have already been recognized, the allowance to non-performing loan ratio was 109.8%. The allowance for loan losses to total loans was 1.24%. Excluding loans acquired in the Capital Bank acquisition, the allowance for loan losses to total loans was 1.57% and represents an amount that management believes is adequate to absorb probable incurred loan losses on existing loans.

The allocated portions of the allowance reflect management's estimates of specific known risk elements in the respective portfolios. Management's methodology followed in evaluating the allowance for loan losses includes a detailed analysis of historical loss factors for pools of similarly graded loans, as well as specific collateral reviews of relationships graded special mention, substandard or doubtful with outstanding balances of \$1.0 million or greater. Among the factors considered in allocating portions of the allowance by loan type are the current levels of past due, non-accrual and impaired loans, as well as historical loss experience and the evaluation of collateral. In addition, management has formally documented factors considered in determining the appropriate level of general reserves, including current economic conditions, forecasted trends in the credit quality cycle, loan growth, entry into new markets, and industry and peer group trends. These amounts have been included in the allocated portion of the loan categories to which they relate.

At June 30, 2011, in addition to the qualitative factors allocated within the allowance, the Corporation maintained \$517 thousand of the allowance as unallocated. While some preliminary improvements have been seen in the local economy and while some loans have improved, the recovery is still very fragile and management believes it is prudent to see a longer period of sustained improvement before completely reflecting this in the allowance. Additionally, management monitors coverage ratios of nonperforming loans and total loans compared to peers on a regular basis. This analysis also suggests that it would not be prudent to eliminate the unallocated portion of the allowance at this time.



Activity in the allowance for loan losses was as follows:

| (dollars in thousands)                 | Six Months Ended June 30, |           |
|--|---------------------------|-----------|
|  | 2011                      | 2010      |
| Balance at beginning of period         | \$ 9,498                  | \$ 9,967  |
| Charge-offs:                           |                           |           |
| Commercial, financial and agricultural | (3)                       | (44)      |
| Commercial mortgages                   | (4)                       | -         |
| Residential mortgages                  | -                         | (36)      |
| Consumer loans                         | (340)                     | (505)     |
| Total                                  | (347)                     | (585)     |
| Recoveries:                            |                           |           |
| Commercial, financial and agricultural | 205                       | 222       |
| Commercial mortgages                   | 26                        | -         |
| Residential mortgages                  | 30                        | -         |
| Consumer loans                         | 94                        | 93        |
| Total                                  | 355                       | 315       |
| Net recoveries (charge-offs)           | 8                         | (270)     |
| Provision charged to operations        | 250                       | 750       |
| Balance at end of period               | \$ 9,756                  | \$ 10,447 |

#### Results of Operations

##### Second Quarter of 2011 vs. Second Quarter of 2010

Net income for the second quarter of 2011 totaled \$2.620 million, an increase of \$117 thousand as compared to second quarter 2010 net income of \$2.503 million. Earnings per share decreased 17.4% from \$0.69 per share to \$0.57 per share on 1,026,724 additional average shares outstanding primarily resulting from the FOFC acquisition. The decrease in earnings per share is attributable to direct transaction costs incurred during the second quarter of this year totaling \$1.187 million related to the Corporation's acquisition of FOFC, which closed on April 8, 2011. Excluding these costs, second quarter 2011 net income would have totaled approximately \$3.375 million or \$0.73 per share with the FOFC acquisition contributing an estimated \$1.141 million of that total or \$0.25 per share.

Net interest income compared to the second quarter of 2011 increased \$2.673 million or 30.4% to \$11.451 million, with the net interest margin increasing 24 basis points to 4.08%. We attribute this increase to the FOFC acquisition as a \$210.2 million or 22.9% increase in average earning assets and a 36 basis point decrease in the cost of average interest bearing liabilities was partially offset by a 6 basis point decrease in the yield on average earning assets to 4.71%. The \$210.2 million increase in average earning assets included a \$178.4 million increase in average loans, with Capital Bank loans accounting for \$152.9 million of this increase, a \$23.1 million increase in average interest bearing deposits and an \$8.7 million increase in the average investment portfolio. The second quarter increase in the average investment portfolio included \$43.3 million of average Capital Bank securities, partially offset by a \$34.6 million decrease in the average balances of other securities. While average earning assets increased 22.9%, total interest and dividend income increased 21.6% or \$2.348 million as the average yield on average earning assets decreased, as noted above.



Total average funding liabilities, including non-interest bearing demand deposits, as compared to the second quarter of last year, increased \$197.9 million or 22.0% to \$1.096 billion as average deposits and borrowings increased \$179.4 million and \$18.5 million, respectively. In total, average non-interest bearing deposits increased \$48.1 million, with Capital Bank non-interest bearing deposits comprising \$23.6 million of that increase. Average interest bearing deposits increased \$131.3 million due to \$153.8 million in Capital Bank average interest bearing deposits, offset by decreases in other average interest bearing balances. The increase in average interest bearing deposits was reflected principally in a \$69.2 million increase in average savings account balances, as well as increases in average time deposits and NOW accounts totaling \$40.1 million and \$26.8 million, respectively. These increases were partially offset by a \$4.8 million decrease in average IMMA balances. The increase in average borrowings was due principally to an increase in borrowings assumed by the Corporation in the FOFC acquisition. While average interest-bearing liabilities increased \$149.8 million, or 21.2%, interest expense decreased \$324 thousand or 15.4%, as the average cost of interest-bearing liabilities decreased 36 basis points to 0.84%.

As discussed under the Asset Quality section of this report, a \$250 thousand decrease in the provision for loan losses was principally due to stable credit quality and a decrease in net charge-offs, as well as management's evaluation of the adequacy of the allowance for loan losses based upon a number of factors, including an analysis of historical loss factors, the evaluation of collateral, recent charge-off experience, overall credit quality, current economic conditions and loan growth.

Non-interest income during the second quarter of 2011 increased \$79 thousand or 1.7% compared to the second quarter of 2010. The most significant factors in this increase included a \$82 thousand increase in check card interchange fee income, a \$76 thousand decrease in other-than-temporary impairment ("OTTI") charges on two CDO's consisting of pools of trust preferred securities issued by other financial institutions which reflects a reduced level of deterioration in the credit quality of the underlying issuers, a \$59 thousand increase in revenue of CFS Group, Inc. and a \$55 thousand increase in gains on the sale of other real estate owned ("OREO"). The above increases were partially offset primarily by a \$216 thousand decrease in Wealth Management Group (formerly referred to as Trust and Investment Center) fee income, which was related to the closing of a large estate during the fourth quarter of 2010.

Second quarter 2011 operating expenses were \$2.786 million or 29.6% higher than the comparable period last year, due in large part to the aforementioned direct acquisition transaction costs totaling \$1.187 million. Excluding these costs, all other operating expenses increased \$1.599 million or 17.0%. This increase was principally due to a \$578 thousand increase in salaries, a \$174 thousand increase in net occupancy costs, a \$222 thousand increase in professional services and a \$211 thousand increase in data processing costs. The increase in salaries reflects addition to staff resulting from the FOFC acquisition, as well as merit increases over the past year. Higher net occupancy costs were principally due to the FOFC acquisition, while the increase in professional services fees was due in large part to higher Wealth Management Group legal and fiduciary tax preparation fees. The increase in data processing costs was impacted by higher mainframe, communication line charges and check card processing fees. Other expense increases included a \$108 thousand increase in amortization of intangible assets resulting from the FOFC acquisition and a \$97 thousand increase in pension and other employee benefits, due in large part to higher health insurance costs. These increases were offset primarily by a \$130 thousand decrease in FDIC insurance resulting from the institution of a new basis by the FDIC for establishing the regular quarterly assessments which took effect at the beginning of the second quarter and an \$89 thousand decrease in OREO expenses due principally to a write-down taken during the second quarter of last year.

A \$98 thousand increase in income tax expense reflects a \$215 thousand increase in pre-tax income, as well as an increase in the effective tax rate from 31.5% to 32.3% due to a decrease in the relative percentage of tax exempt income to pre-tax income.

#### Year-to-Date 2011 vs. Year-to-Date 2010

Net income for the six-month period ended June 30, 2011 totaled \$4.285 million, a decrease of \$218 thousand compared to the corresponding period in 2010. Earnings per share decreased 16.8% from \$1.25 to \$1.04 per share on 522,355 additional average shares outstanding. As was the case with second quarter results, management attributes this decrease to direct transaction costs incurred during the first six months of this year related to the Corporation's acquisition of FOFC totaling \$2.223 million. Excluding these costs, net income for the six-month period ended June 30, 2011 would have totaled approximately \$5.720 million or \$1.39 per share, with the FOFC acquisition contributing an estimated \$1.115 million or \$0.27 per share.

Net interest income compared to the first six months of 2010 increased \$2.706 million or 15.7% with the net interest margin increasing 13 basis points to 3.97%. Once again, management attributes this increase to the FOFC acquisition as a \$106.4 million or 11.7% increase in average earning assets and a 38 basis point decrease in the cost of average interest bearing liabilities was partially offset by an 18 basis point decrease in the yield on average earning assets. The \$106.4 million increase in average earning assets included a \$102.7 million increase in average loans, with Capital Bank loans contributing \$76.9 million to this increase, and a \$5.2 million increase in average interest bearing deposits. The average investment portfolio decreased \$1.6 million as average investments acquired in the Capital Bank acquisition totaling \$21.8 million were offset by a decrease in other average investment securities. While on average, earning assets increased 11.7%, total interest and dividend income increased \$1.659 million or 7.6%, as the average yield on earning assets decreased 18 basis points to 4.65%.

Total average funding liabilities, including non-interest bearing demand deposits, as compared to the first six months of last year, increased \$93.6 million or 10.5% to \$986.4 million as average deposits and borrowings increased \$89.5 million and \$4.1 million, respectively. In total, average non-interest bearing deposits increased \$33.9 million, with Capital Bank non-interest bearing deposits comprising \$11.9 million of that increase. Average interest bearing deposits increased \$55.6 million due to \$77.3 million in Capital Bank average interest bearing deposits, offset by decreases in other average interest bearing balances. The increase in average interest bearing deposits was reflected principally in a \$39.4 million increase in average savings account balances, as well as increases in average NOW and time deposits totaling \$15.6 million and \$7.1 million, respectively. These increases were partially offset by a \$6.4 million decrease in average IMMA balances. The increase in average borrowings was due to borrowings assumed by the Corporation in the FOFC acquisition. While average interest-bearing liabilities increased \$59.7 million or 8.5%, interest expense decreased \$1.047 million or 23.5%, as the average cost of interest-bearing liabilities decreased 38 basis points to 0.90%.

As discussed under the Asset Quality section of this report, a \$500 thousand decrease in the provision for loan losses reflects overall stability in credit quality and a decrease in net charge-offs, as well as management's evaluation of the adequacy of the allowance for loan losses based upon a number of factors, including an analysis of historical loss factors, the evaluation of collateral, recent charge-off experience, overall credit quality, current economic conditions and loan growth.

Non-interest income for the first half of 2011 was \$432 thousand or 5.0% higher than the comparable period last year. This increase was due in part to a \$442 thousand increase in revenue from the Corporation's equity investment in Cephass Capital Partners, L.P., a small business investment company limited partnership, due in large part to a gain recognized on the exercise of stock warrants held in one of its investments. Additionally impacting the improvement in non-interest income was a \$337 thousand decrease in OTTI charges on the aforementioned trust preferred securities pools held in the Corporation's investment portfolio and a \$228 thousand increase in realized gains on the sale of securities, as well as increases in check card interchange fee income and revenue of CFS Group, Inc. totaling \$162 thousand and \$149 thousand, respectively. These increases were partially offset primarily by a \$689 thousand decrease in Wealth Management Group fee income and a \$272 thousand decrease in service charges. The decrease in Wealth Management Group fee income was due to the previously mentioned closing of a large estate during the fourth quarter of last year, while the decrease in service charges was primarily due to lower net overdraft fee income.

Year-to-date operating expenses were \$3.984 million or 21.4% higher than last year, due in large part to the aforementioned direct acquisition transaction costs totaling \$2.223 million. Excluding these costs, all other operating expenses increased \$1.761 million or 9.4%. The most significant factors affecting this increase included a \$668 thousand increase in salaries, a \$270 thousand increase in data processing costs, a \$226 thousand increase in net occupancy costs and a \$223 thousand increase in professional services. As was the case in the second quarter, the increase in salaries reflects addition to staff resulting from the Capital Bank acquisition, as well as merit increases over the past year. The increase in data processing includes higher Wealth Management Group and check card processing costs, as well as increases in main frame and communication line charges. Higher net occupancy costs include costs related to the Capital Bank acquisition, as well as higher maintenance costs at other offices, while the increase in professional services fees was due in large part to higher Wealth Management Group legal and fiduciary tax preparation fees. Other significant expense increases included a \$106 thousand increase in pension and other employee benefits due in large part to an increase in health insurance costs, a \$95 thousand increase in amortization of intangible assets resulting from the FOFC acquisition and an \$87 thousand increase in furniture and equipment costs. These increases were offset primarily by a \$183 thousand decrease in FDIC insurance and a \$144 thousand decrease in OREO expenses.

A \$128 thousand decrease in income tax expense was principally due to the \$346 thousand decrease in pre-tax income, while the decrease in the effective tax rate from 31.1% to 30.8% reflects a \$48 thousand decrease of a previously recognized provision for an uncertain tax position which has since been settled with the Internal Revenue Service.

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Average Consolidated Balance Sheet and Interest Analysis (dollars in thousands)

|  | Six Months Ended<br>June 30, 2011 |               |                | Six Months Ended<br>June 30, 2010 |               |                | Three Months Ended<br>June 30, 2011 |               |              | Three<br>Jun       |
|--|-----------------------------------|---------------|----------------|-----------------------------------|---------------|----------------|-------------------------------------|---------------|--------------|--------------------|
|  | Average<br>Balance                | Interest      | Yield/<br>Rate | Average<br>Balance                | Interest      | Yield/<br>Rate | Average<br>Balance                  | Interest      | Rate         | Average<br>Balance |
| <b>Assets</b>  |                                   |               |                |                                   |               |                |                                     |               |              |                    |
| <b>Earning assets:</b>   |                                   |               |                |                                   |               |                |                                     |               |              |                    |
| Loans  | \$ 690,759                        | \$ 19,783     | 5.78%          | \$ 588,073                        | \$ 17,670     | 6.06%          | \$ 765,918                          | \$ 11,208     | 5.87%        | \$ 587,487         |
| Taxable securities   | 201,575                           | 2,842         | 2.84%          | 212,307                           | 3,414         | 3.24%          | 226,177                             | 1,594         | 2.83%        | 230,136            |
| Tax-exempt securities  | 51,203                            | 685           | 2.70%          | 42,050                            | 588           | 2.82%          | 55,034                              | 369           | 2.69%        | 42,379             |
| Federal funds sold   | -                                 | -             | N/A            | -                                 | -             | N/A            | -                                   | -             | N/A          | -                  |
| Interest-bearing deposits  | 71,810                            | 102           | 0.29%          | 66,564                            | 82            | 0.25%          | 79,085                              | 62            | 0.31%        | 56,022             |
| <b>Total earning assets</b>  | <b>1,015,347</b>                  | <b>23,412</b> | <b>4.65%</b>   | <b>908,994</b>                    | <b>21,754</b> | <b>4.83%</b>   | <b>1,126,214</b>                    | <b>13,233</b> | <b>4.71%</b> | <b>916,024</b>     |
| <b>Non-earning assets:</b>   |                                   |               |                |                                   |               |                |                                     |               |              |                    |
| Cash and due from banks  | 21,667                            |               |                | 22,310                            |               |                | 22,564                              |               |              | 21,255             |
| Premises and equipment, net  | 24,240                            |               |                | 24,568                            |               |                | 24,447                              |               |              | 24,389             |
| Other assets   | 42,812                            |               |                | 38,151                            |               |                | 51,959                              |               |              | 38,199             |
| Allowance for loan losses  | (9,648)                           |               |                | (10,210)                          |               |                | (9,702)                             |               |              | (10,318)           |
| AFS valuation allowance  | 10,655                            |               |                | 8,949                             |               |                | 11,675                              |               |              | 9,552              |
| <b>Total</b>   | <b>\$ 1,105,073</b>               |               |                | <b>\$ 992,762</b>                 |               |                | <b>\$ 1,227,157</b>                 |               |              | <b>\$ 999,101</b>  |
| <b>Liabilities and Shareholders' Equity</b>  |                                   |               |                |                                   |               |                |                                     |               |              |                    |
| <b>Interest-bearing liabilities:</b>   |                                   |               |                |                                   |               |                |                                     |               |              |                    |
| Interest-bearing demand deposits   | 67,454                            | 37            | 0.11%          | 51,889                            | 26            | 0.10%          | 81,437                              | 26            | 0.13%        | 54,634             |
| Savings and insured money market deposits  | 331,690                           | 416           | 0.25%          | 298,684                           | 553           | 0.37%          | 368,448                             | 240           | 0.26%        | 304,041            |
| Time deposits  | 285,286                           | 1,735         | 1.23%          | 278,233                           | 2,538         | 1.84%          | 316,417                             | 894           | 1.13%        | 276,358            |
| Federal Home Loan Bank advances and securities sold under agreements to Repurchase | 76,661                            | 1,227         | 3.23%          | 72,572                            | 1,346         | 3.74%          | 88,485                              | 622           | 2.82%        | 69,967             |
| <b>Total interest-bearing liabilities</b>  | <b>761,091</b>                    | <b>3,415</b>  | <b>0.90%</b>   | <b>701,378</b>                    | <b>4,463</b>  | <b>1.28%</b>   | <b>854,787</b>                      | <b>1,782</b>  | <b>0.84%</b> | <b>705,000</b>     |

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Non-interest-bearing liabilities:

|                          |              |            |           |            |
|--------------------------|--------------|------------|-----------|------------|
| Demand deposits          | 225,338      | 191,416    | 241,266   | 193,184    |
| Other liabilities        | 7,376        | 7,324      | 7,794     | 7,161      |
| Total liabilities        | 993,805      | 900,118    | 1,103,847 | 905,345    |
| Shareholders' equity     | 111,268      | 92,644     | 123,310   | 93,756     |
|                          |              |            | 1,227,    |            |
| Total                    | \$ 1,105,073 | \$ 992,762 | \$ 157    | \$ 999,101 |
| Net interest income      | \$ 19,997    | \$ 17,291  | \$ 11,451 |            |
| Net interest rate spread |              | 3.75%      | 3.55%     | 3.87%      |
| Net interest margin      |              | 3.97%      | 3.84%     | 4.08%      |

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The following table sets forth for the periods indicated, a summary of the changes in interest and dividends earned and interest paid resulting from changes in volume and changes in rates (dollars in thousands):

|  | Six Months Ended June 30, 2011<br>Compared to Six Months Ended<br>June 30, 2010 |            |            | Three Months Ended June 30, 2011<br>Compared to Three Months Ended<br>June 30, 2010 |          |          |
|--|---|------------|------------|---|----------|----------|
|  | Increase (Decrease) Due to (1)  |            |            | Increase (Decrease) Due to (1)  |          |          |
|  | Volume  | Rate       | Net        | Volume  | Rate     | Net      |
| Interest and dividends earned on:  |   |            |            |   |          |          |
| Loans  | \$ 2,972  | \$ (859)   | \$ 2,113   | \$ 2,617  | \$ (255) | \$ 2,362 |
| Taxable securities   | (166)   | (406)      | (572)      | (29)  | (86)     | (115)    |
| Tax-exempt securities  | 125   | (28)       | 97         | 85  | (11)     | 74       |
| Interest-bearing deposits  | 7   | 13         | 20         | 16  | 11       | 27       |
| Total earning assets   | \$ 2,476  | \$ (818)   | \$ 1,658   | \$ 2,471  | (123)    | 2,348    |
| Interest paid on:  |   |            |            |   |          |          |
| Demand deposits  | \$ 8  | \$ 3       | \$ 11      | \$ 7  | \$ 6     | \$ 13    |
| Savings and insured money market deposits  | 56  | (193)      | (137)      | 44  | (32)     | 12       |
| Time deposits  | 63  | (866)      | (803)      | 158   | (474)    | (316)    |
| Federal Home Loan Bank advances and securities sold under agreements to repurchase | 73  | (192)      | (119)      | 151   | (184)    | (33)     |
| Total interest-bearing liabilities   | \$ 355  | \$ (1,403) | \$ (1,048) | \$ 392  | \$ (716) | \$ (324) |
| Net interest income  | \$ 2,121  | \$ 585     | \$ 2,706   | \$ 2,079  | \$ 593   | \$ 2,672 |

(1) The change in interest due to both rate and volume has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

### Liquidity and Capital Resources

Liquidity management involves the ability to meet the cash flow requirements of deposit customers, borrowers, and the operating, investing, and financing activities of the Corporation. The Corporation uses a variety of resources to meet its liquidity needs. These include short term investments, cash flow from lending and investing activities, core deposit growth and non-core funding sources, such as time deposits of \$100,000 or more, securities sold under agreements to repurchase and other borrowings.

The Corporation is a member of the Federal Home Loan Bank of New York which allows it to access borrowings which enhance management's ability to satisfy future liquidity needs. Based on available collateral and current

advances outstanding, the Corporation was eligible to borrow up to a total of \$76.8 million and \$64.8 million at June 30, 2011 and June 30, 2010, respectively.

During the first six months of 2011, cash and cash equivalents increased \$23.3 million as compared to an increase of \$5.7 million during the first six months of last year. In addition to cash provided by operating activities, major sources of cash during the first six months of 2011 included proceeds from sales, maturities, calls and principal reductions on securities totaling \$73.8 million, a \$27.1 million increase in deposits and \$26.2 million in net cash received in the FOFC acquisition. These proceeds were used primarily to fund purchases of securities totaling \$83.9 million, a net decrease in securities sold under agreements to repurchase totaling \$13.1 million, a \$10.6 million net increase in loans, the payment of cash dividends in the amount of \$1.8 million and purchases of fixed assets totaling \$722 thousand.

In addition to cash provided by operating activities, major sources of cash during the first half of 2010 included proceeds from sales, maturities, calls and principal reductions on securities totaling \$78.5 million, a \$31.4 million increase in deposits and a \$6.2 million decrease in loans. Proceeds from the above were used primarily to fund purchases of securities totaling \$103.9 million, a \$9.0 million decrease in securities sold under agreements to repurchase, the payment of cash dividends in the amount of \$1.8 million and purchases of fixed assets totaling \$705 thousand.

As of June 30, 2011, the Bank's leverage ratio was 7.59%. The Tier I and Total Risk Adjusted Capital ratios were 10.91% and 12.40%, respectively. All of the above ratios are in excess of the requirements for being considered "well capitalized" by the FDIC, the Federal Reserve and the New York State Banking Department.

During the first six months of 2011 the Corporation declared cash dividends totaling \$0.50 per share, unchanged from the dividends declared during the first six months of 2010.

When shares of the Corporation become available in the market, we may purchase them after careful consideration of our capital position. On November 17, 2010, the Corporation's Board of Directors approved a one year extension of the stock repurchase program that had been initially approved on November 18, 2009. The extension authorizes the purchase of up to 90,000 shares of the Corporation's outstanding common stock, including those shares purchased during the first year of the plan. Purchases may be made from time to time on the open market or in privately negotiated transactions at the discretion of management. During the first six months of 2011, the Corporation purchased 7,844 treasury shares at an average price of \$23.40 per share. Through June 30, 2011, a total of 28,575 shares had been purchased under this program. During the first six months of 2011, 16,443 shares were re-issued from treasury to fund the stock component of directors' 2010 compensation, distributions under the Corporation's directors' deferred stock plan, a stock grant to an executive officer, a restricted stock award to an executive officer and funding for the Corporation's profit sharing, savings and investment plan.

#### Interest Rate Risk

As intermediaries between borrowers and savers, commercial banks incur both interest rate risk and liquidity risk. The Corporation's Asset/Liability Committee (ALCO) has the strategic responsibility for setting the policy guidelines on acceptable exposure to these areas. These guidelines contain specific measures and limits regarding these risks, which are monitored on a regular basis. The ALCO is made up of the president & chief executive officer, two executive vice presidents, the chief financial officer, the asset liability management officer, the senior marketing officer, and others representing key functions.

The ALCO is also responsible for supervising the preparation and annual revisions of the financial segments of the annual budget, which is built upon the committee's economic and interest-rate assumptions. It is the responsibility of the ALCO to modify prudently the Corporation's asset/liability policies.



Interest rate risk is the risk that net interest income will fluctuate as a result of a change in interest rates. It is the assumption of interest rate risk, along with credit risk, that drives the net interest margin of a financial institution. For that reason, the ALCO has established tolerance limits based upon a 200-basis point change in interest rates. At June 30, 2011, it is estimated that an immediate 200-basis point decrease in interest rates would negatively impact the next 12 months net interest income by 9.82% and an immediate 200-basis point increase would negatively impact the next 12 months net interest income by 1.46%. Both are within the Corporation's policy guideline of 15% established by ALCO. Given the overall low level of current interest rates and the unlikely event of a 200-basis point decline from this point, management additionally modeled an immediate 100-basis point decline and an immediate 300-basis point increase in interest rates. When applied, it is estimated these scenarios would result in negative impacts to net interest income of 4.47% and 3.95%, respectively. Management is comfortable with the level of exposures at these levels.

A related component of interest rate risk is the expectation that the market value of our capital account will fluctuate with changes in interest rates. This component is a direct corollary to the earnings-impact component: an institution exposed to earnings erosion is also exposed to shrinkage in market value. At June 30, 2011, it is estimated that an immediate 200-basis point decrease in interest rates would negatively impact the market value of our capital account by 8.98% and an immediate 200-basis point increase in interest rates would negatively impact the market value by 2.02%. Both are within the established tolerance limit of 15%. Management also modeled the impact to the market value of our capital with an immediate 100-basis point decline and an immediate 300-basis point increase in interest rates, based on the current interest rate environment. When applied, it is estimated these scenarios would result in negative impacts to the market value of our capital of 4.92% and 4.67%, respectively. Management is also comfortable with the level of exposures at these levels.

Management does recognize the need for certain hedging strategies during periods of anticipated higher fluctuations in interest rates and the Board-approved Funds Management Policy provides for limited use of certain derivatives in asset liability management. These strategies were not employed during the first six months of 2011.

Item 3: Quantitative and Qualitative Disclosures About Market Risk

Information required by this Item is set forth herein in Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading "Interest Rate Risk."

Item 4: Controls and Procedures

The Corporation's management, with the participation of our President and Chief Executive Officer, who is the Corporation's principal executive officer, and our Treasurer and Chief Financial Officer, who is the Corporation's principal financial officer, has evaluated the effectiveness of the Corporation's disclosure controls and procedures as of June 30, 2011 pursuant to Rule 13a-15 of the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the principal executive officer and principal financial officer have concluded that the Corporation's disclosure controls and procedures are effective as of June 30, 2011.

During the six months ended June 30, 2011, there have been no changes in the Corporation's internal control over financial reporting that have materially affected, or that are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in the risk factors set forth in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission on March 16, 2011.

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

(c) Issuer Purchases of Equity Securities (1)

| Period                | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Maximum number of shares that may yet be purchased under the plans or programs |
|-----------------------|----------------------------------|------------------------------|--|--|
| 4/1/11-4/30/11        | 5,674                            | \$ 23.55                     | 5,674  | 63,625   |
| 5/1/11-5/31/11        | 2,000                            | 23.00                        | 2,000  | 61,625   |
| 6/1/11-6/30/11        | 200                              | 23.25                        | 200  | 61,425   |
| Quarter ended 6/30/11 | 7,844                            | \$ 23.40                     | 7,844  | 61,425   |

(1) On November 17, 2010, the Corporation's Board of Directors approved a one year extension of the stock repurchase program that had been initially approved on November 18, 2009. The extension authorizes the purchase of up to 90,000 shares of the Corporation's outstanding common stock, including those shares purchased during the first year of the plan. Purchases will be made from time to time on the open-market or in privately negotiated transactions, and will be at the discretion of management.

Item 6. EXHIBITS

The following exhibits are either filed with this Form 10-Q or are incorporated herein by reference:

3.1 Certificate of Incorporation of Chemung Financial Corporation dated December 20, 1984. Filed as Exhibit 3.1 to Registrant's Form 10-K filed with the SEC on March 13, 2008 and incorporated herein by reference.

3.2 Certificate of Amendment to the Certificate of Incorporation of Chemung Financial Corporation, dated March 28, 1988. Filed as Exhibit 3.2 to Registrant's Form 10-K filed with the SEC on March 13, 2008 and incorporated herein by reference.

3.3 Certificate of Amendment to the Certificate of Incorporation of Chemung Financial Corporation, dated May 13, 1998. Filed as Exhibit 3.4 of the Registrant's Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.

3.4 Amended and Restated Bylaws of the Registrant, as amended to December 15, 2010. Filed as Exhibit 3.4 to Registrant's Form 10-K filed with the SEC on March 16, 2011 and incorporated herein by reference.

10.14 Change of Control Agreement dated April 8, 2011 between Chemung Canal Trust Company and Anders M. Tomson, President Capital Bank Division. Filed as

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Exhibit 10.14 to Registrant's Form 10-Q filed with the SEC on May 13, 2011 and incorporated herein by reference.\*

31.1 Certification of President and Chief Executive Officer of the Registrant pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.

31.2 Certification of Treasurer and Chief Financial Officer of the Registrant pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.

32.1 Certification of President and Chief Executive Officer of the Registrant pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. §1350.

32.2 Certification of Treasurer and Chief Financial Officer of the Registrant pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. §1350.

\* Denotes management contract or compensatory plan.

SIGNATURES

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

CHEMUNG FINANCIAL CORPORATION

DATE: August 19, 2011 /s/ Ronald M. Bentley  
Ronald M. Bentley  
President & Chief Executive Officer

DATE: August 19, 2011 /s/ John R. Battersby Jr.  
John R. Battersby Jr.  
Treasurer & Chief Financial Officer  
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

3.1 Certificate of Incorporation of Chemung Financial Corporation dated December 20, 1984. Filed as Exhibit 3.1 to Registrant's Form 10-K filed with the SEC on March 13, 2008 and incorporated herein by reference.

3.2 Certificate of Amendment to the Certificate of Incorporation of Chemung Financial Corporation, dated March 28, 1988. Filed as Exhibit 3.2 to Registrant's Form 10-K filed with the SEC on March 13, 2008 and incorporated herein by reference.

3.3 Certificate of Amendment to the Certificate of Incorporation of Chemung Financial Corporation, dated May 13, 1998. Filed as Exhibit 3.4 of the Registrant's Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.

3.4 Amended and Restated Bylaws of the Registrant, as amended to December 15, 2010. Filed as Exhibit 3.4 to Registrant's Form 10-K filed with the SEC on March 16, 2011 and incorporated herein by reference.

10.14 Change of Control Agreement dated April 8, 2011 between Chemung Canal Trust Company and Anders M. Tomson, President Capital Bank Division. Filed as Exhibit 10.14 to Registrant's Form 10-Q filed with the SEC on May 13, 2011 and incorporated herein by reference.\*

31.1 Certification of President and Chief Executive Officer of the Registrant pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.

31.2 Certification of Treasurer and Chief Financial Officer of the Registrant pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.

32.1 Certification of President and Chief Executive Officer of the Registrant pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. §1350.

32.2 Certification of Treasurer and Chief Financial Officer of the Registrant pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. §1350.

\* Denotes management contract or compensatory plan

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