EVANS BANCORP INC
Form 10-Q
May 02, 2014

United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For quarterly period ended March 31, 2014

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

For the transition period from to .

Commission file number 001-35021

EVANS BANCORP, INC. .

(Exact name of registrant as specified in its charter)

New York 16-1332767

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

One Grimsby Drive, Hamburg, NY 14075

(Address of principal executive offices) (Zip Code)

(716) 926-2000 .

(Registrant's telephone number, including area code)

.

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

since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Large accelerated filer Accelerated filer

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

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

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

Common Stock, $.50 par value: 4,170,621 shares as of April 30, 2014

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EVANS BANCORP, INC. AND SUBSIDIARIES

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS
MARCH 31, 2014 AND DECEMBER 31, 2013
(in thousands, except share and per share amounts)

	March 31, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$ 16,743	$ 14,698
Interest-bearing deposits at banks	30,102	27,256
Securities:		
Available for sale, at fair value (amortized cost: $93,698 at March 31, 2014; $99,353 at December 31, 2013)	94,598	99,665
Held to maturity, at amortized cost (fair value: $2,322 at March 31, 2014; $2,319 at December 31, 2013)	2,373	2,384
Federal Home Loan Bank common stock, at amortized cost	1,364	1,364
Federal Reserve Bank common stock, at amortized cost	1,476	1,467
Loans and leases, net of allowance for loan and lease losses of $11,734 at March 31, 2014 and $11,503 at December 31, 2013	648,961	635,493
Properties and equipment, net of accumulated depreciation of $14,499 at March 31, 2014 and $14,226 at December 31, 2013	11,117	11,163
Goodwill	8,101	8,101
Intangible assets	67	108
Bank-owned life insurance	19,986	19,840
Other assets	11,988	11,959
TOTAL ASSETS	$ 846,876	$ 833,498
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Demand	$ 139,975	$ 139,973
NOW	79,531	65,927
Regular savings	393,735	390,575
Time	108,702	110,137
Total deposits	721,943	706,612
Securities sold under agreement to repurchase	11,374	13,351
Other short term borrowings	9,000	9,000
Other liabilities	12,712	12,493
Junior subordinated debentures	11,330	11,330

Total liabilities	766,359	752,786
CONTINGENT LIABILITIES AND COMMITMENTS		
STOCKHOLDERS' EQUITY:		
Common stock, $.50 par value, 10,000,000 shares authorized; 4,211,476 and 4,208,459 shares issued at March 31, 2014 and December 31, 2013, respectively, and 4,147,666 and 4,201,362 outstanding at March 31, 2014 and December 31, 2013, respectively	2,108	2,106
Capital surplus	42,710	42,619
Treasury stock, at cost, 62,983 shares and 4,906 at March 31, 2014 and December 31, 2013, respectively	(1,498)	(120)
Retained earnings	38,078	37,370
Accumulated other comprehensive (loss) gain, net of tax	(881)	(1,263)
Total stockholders' equity	80,517	80,712
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 846,876	$ 833,498

See Notes to Unaudited Consolidated Financial Statements

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PART I - FINANCIAL INFORMATION
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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF INCOME
THREE MONTHS ENDED MARCH 31, 2014 AND 2013
(in thousands, except share and per share amounts)

	Three Months Ended March 31,	
	2014	2013
INTEREST INCOME		
Loans and leases	$ 7,510	$ 7,252
Interest bearing deposits at banks	15	18
Securities:		
Taxable	449	417
Non-taxable	245	269
Total interest income	8,219	7,956
INTEREST EXPENSE		
Deposits	756	890
Other borrowings	86	161
Junior subordinated debentures	79	79
Total interest expense	921	1,130
NET INTEREST INCOME	7,298	6,826
PROVISION FOR LOAN AND LEASE LOSSES	153	450
NET INTEREST INCOME AFTER		
PROVISION FOR LOAN AND LEASE LOSSES	7,145	6,376
NON-INTEREST INCOME		
Bank charges	461	482
Insurance service and fees	2,132	1,999
Data center income	107	114
Gain on loans sold	-	25
Bank-owned life insurance	145	113
Other	550	577
Total non-interest income	3,395	3,310
NON-INTEREST EXPENSE		
Salaries and employee benefits	4,695	4,289
Occupancy	743	816
Repairs and maintenance	176	178
Advertising and public relations	222	124

Professional services	518	454
Technology and communications	300	291
Amortization of intangibles	41	63
FDIC insurance	162	138
Other	761	723
Total non-interest expense	7,618	7,076
INCOME BEFORE INCOME TAXES	2,922	2,610
INCOME TAX PROVISION	909	794
NET INCOME	$ 2,013	$ 1,816
Net income per common share-basic	$ 0.48	$ 0.44
Net income per common share-diluted	$ 0.47	$ 0.43
Cash dividends per common share	$ 0.31	$ -
Weighted average number of common shares outstanding	4,200,519	4,173,978
Weighted average number of diluted shares outstanding	4,284,016	4,210,595

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UNAUDITED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME
THREE MONTHS ENDED MARCH 31, 2014 AND 2013
(in thousands, except share and per share amounts)

	Three Months Ended March 31,			
	2014		2013	
NET INCOME		$ 2,013		$ 1,816
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:				
Unrealized gain (loss) on available-for-sale securities:				
Unrealized gain (loss) on available-for-sale securities	361		(261)	
Less: Reclassification of gain on sale of securities	-		-	
		361		(261)
Defined benefit pension plans:				
Amortization of prior service cost	5		10	
Amortization of actuarial loss	16		27	
Total		21		37
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX		382		(224)
COMPREHENSIVE INCOME		$ 2,395		$ 1,592

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UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
THREE MONTHS ENDED MARCH 31, 2014 AND 2013
(in thousands, except share and per share amounts)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance, December 31, 2012	$ 2,087	$ 42,029	$ 30,611	$ 101	$ -	$ 74,828
Net Income			1,816			1,816
Other comprehensive (loss)				(224)		(224)
Stock options and restricted stock expense		75				75
Issued 18,784 restricted shares	9	(9)				-
Balance, March 31, 2013	$ 2,096	$ 42,095	$ 32,427	$ (123)	$ -	$ 76,495
Balance, December 31, 2013	$ 2,106	$ 42,619	$ 37,370	$ (1,263)	$ (120)	$ 80,712
Net Income			2,013			2,013
Other comprehensive income (loss)				382		382
Cash dividends ($0.31 per common share)			(1,305)			(1,305)
Stock options and restricted stock expense		99				99
Excess tax expense from stock-based compensation		21				21
Issued 3,017 restricted shares	2	(2)				-
Repurchased 59,800 shares					(1,436)	(1,436)
Reissued 3,087 shares in stock option exercise		(27)			58	31
Balance, March 31, 2014	$ 2,108	$ 42,710	$ 38,078	$ (881)	$ (1,498)	$ 80,517

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ITEM 1 - FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2014 AND 2013
(in thousands)

	Three Months Ended March 31,	
	2014	2013
OPERATING ACTIVITIES:		
Interest received	$ 8,105	$ 7,638
Fees received	3,388	3,301
Interest paid	(937)	(1,147)
Cash paid to employees and vendors	(8,368)	(8,009)
Cash contributed to pension plan	-	(95)
Income taxes paid	(960)	(461)
Proceeds from sale of loans held for resale	-	776
Originations of loans held for resale	(123)	(233)
Net cash provided by operating activities	1,105	1,770
INVESTING ACTIVITIES:		
Available for sales securities:		
Purchases	-	(3,487)
Proceeds from maturities, calls, and payments	5,543	3,759
Held to maturity securities:		
Proceeds from maturities, calls, and payments	11	11
Additions to properties and equipment	(226)	(47)
Net increase in loans	(13,493)	(5,865)
Net cash used in investing activities	(8,165)	(5,629)
FINANCING ACTIVITIES:		
Proceeds from (repayments of) borrowings	(1,977)	(5,328)
Net increase in deposits	15,333	19,308
Repurchase of treasury stock	(1,436)	-
Reissuance of treasury stock	31	-
Net cash provided by financing activities	11,951	13,980
Net increase (decrease) in cash and equivalents	4,891	10,121
CASH AND CASH EQUIVALENTS:		

Beginning of period	41,954	90,477
End of period	$ 46,845	$ 100,598

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UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2014 AND 2013
(in thousands)

	Three Months Ended March 31,	
	2014	2013
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 2,013	$ 1,816
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	382	567
Deferred tax expense (benefit)	(13)	109
Provision for loan and lease losses	153	450
Gain on loans sold	-	(25)
Stock options and restricted stock expense	99	75
Proceeds from sale of loans held for resale	-	776
Originations of loans held for resale	(123)	(233)
Cash contributed to pension plan	-	(95)
Changes in assets and liabilities affecting cash flow:		
Other assets	(613)	(699)
Other liabilities	(793)	(971)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 1,105	$ 1,770

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PART 1 – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED MARCH 31, 2014 AND 2013

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The results of operations for the three month period ended March 31, 2014 are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited consolidated financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013.

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2. SECURITIES

The amortized cost of securities and their approximate fair value at March 31, 2014 and December 31, 2013 were as follows:

	March 31, 2014 (in thousands)			
	Amortized Cost	Unrealized Gains	Losses	Fair Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 28,075	$ 394	$ (457)	$ 28,012
States and political subdivisions	31,066	979	(107)	31,938
Total debt securities	$ 59,141	$ 1,373	$ (564)	$ 59,950
Mortgage-backed securities:				
FNMA	$ 12,698	$ 388	$ (32)	$ 13,054
FHLMC	6,865	112	(108)	6,869
GNMA	7,212	143	(70)	7,285
CMO	7,782	8	(350)	7,440
Total mortgage-backed securities	$ 34,557	$ 651	$ (560)	$ 34,648
Total securities designated as available for sale	$ 93,698	$ 2,024	$ (1,124)	$ 94,598
Held to Maturity:				
Debt securities				
States and political subdivisions	$ 2,373	$ 7	$ (58)	$ 2,322
Total securities designated as held to maturity	$ 2,373	$ 7	$ (58)	$ 2,322

	December 31, 2013 (in thousands)			
	Amortized Cost	Unrealized Gains	Losses	Fair Value

Available for Sale:				
Debt securities:				
U.S. government agencies	$ 32,176	$ 439	$ (623)	$ 31,992
States and political subdivisions	31,266	802	(188)	31,880
Total debt securities	$ 63,442	$ 1,241	$ (811)	$ 63,872
Mortgage-backed securities:				
FNMA	$ 13,204	$ 354	$ (57)	$ 13,501
FHLMC	7,156	109	(147)	7,118
GNMA	7,570	99	(96)	7,573
CMO	7,981	9	(389)	7,601
Total mortgage-backed securities	$ 35,911	$ 571	$ (689)	$ 35,793
Total securities designated as available for sale	$ 99,353	$ 1,812	$ (1,500)	$ 99,665
Held to Maturity:				
Debt securities				
States and political subdivisions	$ 2,384	$ 6	$ (71)	$ 2,319
Total securities designated as held to maturity	$ 2,384	$ 6	$ (71)	$ 2,319

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Available for sale securities with a total fair value of $93.6 million and $71.1 million at March 31, 2014 and December 31, 2013, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

The Company uses the Federal Home Loan Bank of New York ("FHLBNY") as its primary source of overnight funds and also has several long-term advances with FHLBNY. The Company had a total of $9 million in borrowed funds with FHLBNY at March 31, 2014 and December 31, 2013, respectively. The Company has placed sufficient collateral in the form of residential and commercial real estate loans at FHLBNY that meet FHLB collateral requirements. As a member of the Federal Home Loan Bank ("FHLB") System, the Bank is required to hold stock in FHLBNY. The Bank held $1.4 million in FHLBNY stock as of March 31, 2014 and December 31, 2013 at amortized cost. The Company regularly evaluates investments in FHLBNY for impairment, considering liquidity, operating performance, capital position, stock repurchase and dividend history. At this time, the Company does not believe any impairment in FHLBNY stock is warranted.

The scheduled maturities of debt and mortgage-backed securities at March 31, 2014 and December 31, 2013 are summarized below. All maturity amounts are contractual maturities. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call premiums.

	March 31, 2014		December 31, 2013	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
	(in thousands)		(in thousands)	
Debt securities available for sale:				
Due in one year or less	$ 547	$ 557	$ 447	$ 454
Due after one year through five years	25,494	26,215	23,732	24,419
Due after five years through ten years	25,490	25,280	31,450	30,946
Due after ten years	7,610	7,898	7,813	8,053
	59,141	59,950	63,442	63,872
Mortgage-backed securities available for sale	34,557	34,648	35,911	35,793

Total available for sale securities	$ 93,698	$ 94,598	$ 99,353	$ 99,665
Debt securities held to maturity:				
Due in one year or less	$ 1,023	$ 1,021	$ 1,023	$ 1,020
Due after one year through five years	172	174	178	179
Due after five years through ten years	1,059	1,020	1,064	1,015
Due after ten years	119	107	119	105
	2,373	2,322	2,384	2,319
Total held to maturity securities	$ 2,373	$ 2,322	$ 2,384	$ 2,319

Information regarding unrealized losses within the Company's available for sale securities at March 31, 2014 and December 31, 2013, is summarized below. The securities are primarily U.S. government-guaranteed agency securities or municipal securities. All unrealized losses are considered temporary and related to market interest rate fluctuations.

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	March 31, 2014					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 8,686	$ (352)	$ 1,894	$ (105)	$ 10,580	$ (457)
States and political subdivisions	6,662	(81)	601	(26)	7,263	(107)
Total debt securities	$ 15,348	$ (433)	$ 2,495	$ (131)	$ 17,843	$ (564)
Mortgage-backed securities:						
FNMA	$ 4,657	$ (32)	$ -	$ -	$ 4,657	$ (32)
FHLMC	2,564	(24)	1,665	(84)	4,229	(108)
GNMA	2,582	(70)	-	-	2,582	(70)
CMO'S	6,362	(350)	-	-	6,362	(350)
Total mortgage-backed securities	$ 16,165	$ (476)	$ 1,665	$ (84)	$ 17,830	$ (560)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 1,234	$ (16)	$ 551	$ (42)	$ 1,785	$ (58)
Total temporarily impaired securities	$ 32,747	$ (925)	$ 4,711	$ (257)	$ 37,458	$ (1,182)

December 31, 2013

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 10,553	$ (486)	$ 1,863	$ (137)	$ 12,416	$ (623)
States and political subdivisions	7,953	(150)	590	(38)	8,543	(188)
Total debt securities	$ 18,506	$ (636)	$ 2,453	$ (175)	$ 20,959	$ (811)
Mortgage-backed securities:						
FNMA	$ 4,819	$ (57)	$ 21	$ -	$ 4,840	$ (57)
FHLMC	2,677	(46)	1,700	(101)	4,377	(147)
GNMA	2,751	(96)	-	-	2,751	(96)
CMO'S	6,466	(389)	-	-	6,466	(389)
Total mortgage-backed securities	$ 16,713	$ (588)	$ 1,721	$ (101)	$ 18,434	$ (689)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 1,210	$ (24)	$ 504	$ (47)	$ 1,714	$ (71)
Total temporarily impaired securities	$ 36,429	$ (1,248)	$ 4,678	$ (323)	$ 41,107	$ (1,571)

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In regard to municipal securities, the Company's general investment policy is that in-state securities must be rated at least Moody's Baa (or equivalent) at the time of purchase. The Company reviews the ratings report and municipality financial statements and prepares a pre-purchase analysis report before the purchase of any municipal securities. Out-of-state issues must be rated by Moody's at least Aa (or equivalent) at the time of purchase. The Company did not own any out-of-state municipal bonds at March 31, 2014 or December 31, 2013. Bonds rated below A are reviewed periodically to ensure their continued credit worthiness. While purchase of non-rated municipal securities is permitted under the Company's investment policy, such purchases are limited to bonds issued by municipalities in the Company's general market area. Those municipalities are typically customers of the Bank whose financial situation is familiar to management. The financial statements of the issuers of non-rated securities are reviewed by the Bank and a credit file of the issuers is kept on each non-rated municipal security with relevant financial information.

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

Management has assessed the securities available for sale in an unrealized loss position at March 31, 2014 and December 31, 2013 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities' amortized cost, and the financial condition of the issuer (primarily government or government-sponsored enterprises). In addition, management does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuers.

The Company had not recorded any other-than-temporary impairment ("OTTI") charges as of March 31, 2014 and did not record any OTTI charges during 2013. The gross unrealized losses in the Company's securities portfolio were at an immaterial level during each of those periods. Nevertheless, it remains possible that there could be deterioration in the asset quality of the securities portfolio in the future. The credit worthiness of the Company's portfolio is largely reliant on the ability of U.S. government sponsored agencies such as FHLB, Federal National Mortgage Association ("FNMA"), Government National Mortgage Association ("GNMA"), and Federal Home Loan Mortgage Corporation ("FHLMC"), and municipalities throughout New York State to meet their obligations. In addition, dysfunctional markets could materially alter the liquidity, interest rate, and pricing risk of the portfolio. The relatively stable past performance is not a guarantee for similar performance of the Company's securities portfolio going forward.

3. FAIR VALUE MEASUREMENTS

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

There are three levels of inputs to fair value measurements:

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

Observable market data should be used when available.

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

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The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a recurring basis at March 31, 2014 and December 31, 2013:

(in thousands)	Level 1	Level 2	Level 3	Fair Value
March 31, 2014				
Securities available-for-sale:				
U.S. government agencies	$ -	$ 28,012	$ -	$ 28,012
States and political subdivisions	-	31,938	-	31,938
Mortgage-backed securities	-	34,648	-	34,648
Mortgage servicing rights	-	-	471	471
December 31, 2013				
Securities available-for-sale:				
U.S. government agencies	$ -	$ 31,992	$ -	$ 31,992
States and political subdivisions	-	31,880	-	31,880
Mortgage-backed securities	-	35,793	-	35,793
Mortgage servicing rights	-	-	509	509

Securities available for sale

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

Management believes that it has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of securities to enable management to maintain an appropriate system of internal control. On a quarterly basis, the Company reviews changes in the market value of its security portfolio. Individual changes in valuations are reviewed for consistency with general interest rate movements and any known credit concerns for specific securities. Additionally, on an annual basis, the Company has its entire security portfolio priced by a second pricing service to determine consistency with another market evaluator. If, on the Company's review or in comparing with another servicer, a material difference between pricing evaluations were to exist, the Company may submit an inquiry to the service provider regarding the data used to value a particular security. If the Company determines it has market information that would support a different valuation than the initial evaluation it can submit a challenge for a change to that security's valuation. There were no material differences in valuations noted in the first quarter of 2014 or during fiscal year 2013.

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

Mortgage servicing rights

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

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The following table summarizes the changes in fair value for mortgage servicing rights during the three month periods ended March 31, 2014 and 2013, respectively:

	Three months ended March 31,	
	2014	2013
Mortgage servicing rights - December 31	$ 509	$ 467
Gains (losses) included in earnings	(38)	(20)
Additions from loan sales	-	8
Mortgage servicing rights - March 31	$ 471	$ 455

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

	3/31/2014	12/31/2013
Servicing fees	0.25 %	0.25 %
Discount rate	10.04 %	10.04 %
Prepayment rate (CPR)	9.86 %	9.31 %

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements. The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a nonrecurring basis at March 31, 2014 and December 31, 2013:

(in thousands)	Level 1	Level 2	Level 3	Fair Value
March 31, 2014				
Impaired loans	$ -	-	16,862	$ 16,862
December 31, 2013				
Impaired loans	$ -	-	17,378	$ 17,378

Impaired loans

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

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The Company has an appraisal policy in which appraisals are obtained upon a commercial loan being downgraded on the Company internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired commercial loans are either graded a 6 or 7 on the internal loan rating scale. For consumer loans, the Company obtains appraisals when a loan becomes 90 days past due or is determined to be impaired, whichever occurs first. Subsequent to the downgrade or reaching 90 days past due, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change in the condition of the collateral, or feedback from local appraisers. Impaired loans had a gross value of $18.3 million, with a valuation allowance of $1.4 million, at March 31, 2014, compared to a gross value for impaired loans of $18.9 million, with a valuation allowance of $1.5 million, at December 31, 2013.

FAIR VALUE OF FINANCIAL INSTRUMENTS

At March 31, 2014 and December 31, 2013, the estimated fair values of the Company's financial instruments, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis, were as follows:

	March 31, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
Financial assets:				
Level 1:				
Cash and cash equivalents	$ 46,845	$ 46,845	$ 41,954	$ 41,954
Level 2:				
Available for sale securities	94,598	94,598	99,665	99,665
FHLB and FRB stock	2,840	2,840	2,831	2,831
Level 3:				
Held to maturity securities	2,373	2,322	2,384	2,319
Loans and leases, net	648,961	659,755	635,493	640,770
Mortgage servicing rights	471	471	509	509

Financial liabilities:				
Level 1:				
Demand deposits	$ 139,975	$ 139,975	$ 139,973	$ 139,973
NOW deposits	79,531	79,531	65,927	65,927
Regular savings deposits	393,735	393,735	390,575	390,575
Junior subordinated debentures	11,330	11,330	11,330	11,330
Commitments to extend credit	360	360	401	401
Securities sold under agreement to repurchase	11,374	11,374	13,351	13,351
Level 2:				
Other borrowed funds	9,000	9,105	9,000	9,171
Level 3:				
Time deposits	108,702	110,654	110,137	112,270

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

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

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

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

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

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

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

Commitments to extend credit and standby letters of credit. As described in Note 8 - "Contingent Liabilities and Commitments" to these Unaudited Consolidated Financial Statements, the Company was a party to financial instruments with off-balance sheet risk at March 31, 2014 and December 31, 2013. Such financial instruments consist of commitments to extend permanent financing and letters of credit. If the options are exercised by the prospective borrowers, these financial instruments will become interest-earning assets of the Company. If the options expire, the Company retains any fees paid by the counterparty in order to obtain the commitment or guarantee. The fees collected for these commitments are recorded as "unearned commitment fees" in Other Liabilities. The carrying value approximates the fair value.

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

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

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

Loan and Lease Portfolio Composition

The following table presents selected information on the composition of the Company’s loan and lease portfolio as of the dates indicated:

	March 31, 2014	December 31, 2013
Mortgage loans on real estate:	(in thousands)	
Residential Mortgages	$ 96,435	$ 94,027
Commercial and multi-family	364,012	361,247
Construction-Residential	1,933	1,509
Construction-Commercial	27,761	23,902
Home equities	57,364	57,228
Total real estate loans	547,505	537,913
Commercial and industrial loans	110,944	106,952
Consumer loans	1,054	938
Other	541	323
Net deferred loan origination costs	651	870
Total gross loans	660,695	646,996
Allowance for loan losses	(11,734)	(11,503)
Loans, net	$ 648,961	$ 635,493

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. In the three month period ended March 31, 2014, the Bank did not sell any mortgages to FNMA, as compared with $0.8 million sold during the three month period ended March 31, 2013. At March 31, 2014, the Bank had a loan servicing portfolio principal balance of $62.3 million upon which it earns servicing fees, as compared with $63.5 million at December 31, 2013. The value of the mortgage servicing rights for that portfolio was $0.5 million at March 31, 2014 and December 31, 2013. At March 31, 2014, there were $0.1 million in residential mortgage loans held-for-sale, compared with no residential mortgages held for sale at December 31, 2013. The Company had no commercial loans held-for-sale at March 31, 2014 or December 31, 2013. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

As noted in Note 1, these financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013. Disclosures related to the basis for accounting for loans and leases, the method for recognizing interest income on loans and leases, the policy for placing loans and leases on nonaccrual status and the subsequent recording of payments and resuming accrual of interest, the policy for determining past due status, a description of the Company’s accounting policies and methodology used to estimate the allowance for loan and lease losses, the policy for charging off loans and leases, the accounting policies for impaired loans, and more descriptive information on the Company’s credit risk ratings are all contained in the Notes to the Audited Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. Unless otherwise noted in this Form 10-Q, the policies and methodology described in the Annual Report for the year ended December 31, 2013 are consistent with those utilized by the Company in the three months ended March 31, 2014.

Credit Quality Indicators

The Bank monitors the credit risk in its loan portfolio by reviewing certain credit quality indicators (“CQI”). The primary CQI for its commercial mortgage and commercial and industrial (“C&I”) portfolios is the individual loan’s credit risk rating. The following list provides a description of the credit risk ratings that are used internally by the Bank when assessing the adequacy of its allowance for loan and lease losses:

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- 1-3-Pass
- 4-Watch
- 5-O.A.E.M. (Other Assets Especially Mentioned) or Special Mention
- 6-Substandard
- 7-Doubtful
- 8-Loss

The Company's consumer loans, including residential mortgages and home equities, and commercial leases are not individually risk rated or reviewed in the Company's loan review process. Consumers are not required to provide the Company with updated financial information as is a commercial customer. Consumer loans also carry smaller balances. Given the lack of updated information since the initial underwriting of the loan and small size of individual loans, the Company uses delinquency status as the credit quality indicator for consumer loans.

The following tables provide data, at the class level, of credit quality indicators of certain loans and leases for the dates specified:

March 31, 2014
(in thousands)

Corporate Credit Exposure – By Credit Rating	Commercial Real Estate Construction	Commercial and Multi-Family Mortgages	Total Commercial Real Estate	Commercial and Industrial
3	$ 21,053	$ 304,058	$ 325,111	$ 78,869
4	5,443	42,162	47,605	18,988
5	-	13,649	13,649	9,046
6	1,265	3,911	5,176	3,858
7	-	232	232	183
Total	$ 27,761	$ 364,012	$ 391,773	$ 110,944

December 31, 2013
(in thousands)

Corporate Credit Exposure – By Credit Rating	Commercial Real Estate Construction	Commercial and Multi-Family Mortgages	Total Commercial Real Estate	Commercial and Industrial
3	$ 19,086	$ 297,819	$ 316,905	$ 78,294
4	3,283	47,584	50,867	15,194
5	-	4,028	4,028	9,468
6	1,533	11,479	13,012	3,744
7	-	337	337	252
Total	$ 23,902	$ 361,247	$ 385,149	$ 106,952

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Past Due Loans and Leases

The following tables provide an analysis of the age of the recorded investment in loans and leases that are past due as of the dates indicated:

March 31, 2014
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans and Leases
Commercial and industrial	$ 4,108	$ -	$ 69	$ 4,177	$ 106,767	$ 110,944	$ -	$ 2,808
Residential real estate:								
Residential	633	22	886	1,541	94,894	96,435	-	943
Construction	-	-	-	-	1,933	1,933	-	-
Commercial real estate:								
Commercial	4,515	-	75	4,590	359,422	364,012	-	977
Construction	-	-	-	-	27,761	27,761	-	-
Home equities	881	249	129	1,259	56,105	57,364	-	445
Direct financing leases	-	-	29	29	-	-	-	29
Consumer	1	1	-	2	1,052	1,054	-	18
Other	-	-	-	-	541	541	-	-
Total Loans	$ 10,138	$ 272	$ 1,188	$ 11,598	$ 648,475	$ 660,044	$ -	$ 5,220

NOTE: Loan and lease balances do not include $651 thousand in net deferred loan and lease origination costs as of March 31, 2014.

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December 31, 2013
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans and Leases
Commercial and industrial	$ 197	$ 447	$ 358	$ 1,002	$ 105,950	$ 106,952	$ -	$ 2,970
Residential real estate:								
Residential	392	72	915	1,379	92,648	94,027	-	1,376
Construction	-	-	-	-	1,509	1,509	-	-
Commercial real estate:								
Commercial	6,976	1,050	75	8,101	353,146	361,247	-	8,873
Construction	-	-	-	-	23,902	23,902	-	-
Home equities	100	267	76	443	56,785	57,228	-	447
Direct financing leases	1	2	47	50	-	-	-	47
Consumer	1	21	-	22	916	938	-	20
Other	-	-	-	-	323	323	-	-
Total Loans	$ 7,667	$ 1,859	$ 1,471	$ 10,997	$ 635,179	$ 646,126	$ -	$ 13,733

NOTE: Loan and lease balances do not include $870 thousand in net deferred loan and lease origination costs as of December 31, 2013.

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Allowance for loan and lease losses

The following tables present the activity in the allowance for loan and lease losses according to portfolio segment, for the three month periods ended March 31, 2014 and 2013:

March 31, 2014

(in thousands)	Commercial and Industrial	Commercial Real Estate Mortgages*	Consumer **	Residential Mortgages*	HELOC	Direct Financing Leases	Unallocated	Total
Allowance for loan and lease losses:								
Beginning balance	$ 4,489	$ 4,912	$ 37	$ 1,038	$ 878	$ -	$ 149	$ 11,503
Charge-offs	(57)	-	(6)	-	(1)	-	-	(64)
Recoveries	28	29	2	-	-	83	-	142
Provision	63	167	3	(1)	4	(83)	-	153
Ending balance	$ 4,523	$ 5,108	$ 36	$ 1,037	$ 881	$ -	$ 149	$ 11,734
Allowance for loan and lease losses:								
Ending balance:								
Individually evaluated for impairment	$ 1,182	$ 210	$ 19	$ -	$ -	$ -	$ -	$ 1,411
Collectively evaluated for impairment	3,341	4,898	17	1,037	881	-	149	10,323
Total	$ 4,523	$ 5,108	$ 36	$ 1,037	$ 881	$ -	$ 149	$ 11,734
Loans and leases:								
Ending balance:								
Individually evaluated for impairment	$ 4,291	$ 11,579	$ 19	$ 2,100	$ 284	$ -	$ -	$ 18,273
Collectively evaluated								

for impairment	106,653	380,194	1,576	96,268	57,080	-	-	641,771
Total	$ 110,944	$ 391,773	$ 1,595	$ 98,368	$ 57,364	$ -	$ -	$ 660,044

* Includes construction loans

** Includes other loans

NOTE: Loan and lease balances do not include $651 thousand in net deferred loan and lease origination costs as of March 31, 2014.

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March 31, 2013

(in thousands)	Commercial and Industrial	Commercial Real Estate Mortgages*	Consumer **	Residential Mortgages*	HELOC	Direct Financing Leases	Unallocated	Total
Allowance for loan and lease losses:								
Beginning balance	$ 3,617	$ 4,493	$ 18	$ 662	$ 746	$ 47	$ 149	$ 9,732
Charge-offs	(10)	(13)	(10)	(6)	(91)	-	-	(130)
Recoveries	97	1	3	1	-	-	-	102
Provision	51	266	4	91	85	(47)	-	450
Ending balance	$ 3,755	$ 4,747	$ 15	$ 748	$ 740	$ -	$ 149	$ 10,154
Allowance for loan and lease losses:								
Ending balance:								
Individually evaluated for impairment	$ 387	$ 412	$ 4	$ 5	$ 7	$ -	$ -	$ 815
Collectively evaluated for impairment	3,368	4,335	11	743	733	-	149	9,339
Total	$ 3,755	$ 4,747	$ 15	$ 748	$ 740	$ -	$ 149	$ 10,154
Loans and leases:								
Ending balance:								
Individually evaluated for impairment	$ 1,417	$ 7,867	$ 20	$ 1,441	$ 573	$ 115	$ -	$ 11,433
Collectively evaluated for impairment	104,565	340,699	1,367	74,263	54,214	814	-	575,922
Total	$ 105,982	$ 348,566	$ 1,387	$ 75,704	$ 54,787	$ 929	$ -	$ 587,355

* Includes construction loans

** Includes other loans

NOTE: Loan and lease balances do not include $731 thousand in net deferred loan and lease origination costs as of March 31, 2013.

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Impaired Loans and Leases

The following tables provide data, at the class level, of impaired loans and leases as of the dates indicated:

	At March 31, 2014					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Foregone	Interest Income Recognized
With no related allowance recorded:	(in thousands)					
Commercial and industrial	$ 1,162	$ 1,361	$ -	$ 1,337	$ 33	$ 9
Residential real estate:						
Residential	2,100	2,334	-	2,009	-	13
Construction	-	-	-	-	-	-
Commercial real estate:						
Commercial	9,747	10,147	-	9,711	-	69
Construction	330	330	-	631	-	3
Home equities	284	312	-	414	-	-
Direct financing leases	-	-	-	-	-	-
Consumer	-	-	-	-	-	-