

CHEMUNG FINANCIAL CORP

Form 10-Q

August 08, 2013

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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, 2013

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   | 16-1237038                         |
| (State or other jurisdiction of incorporation or organization) | I.R.S. Employer Identification No. |

|  |            |
|--|------------|
| One Chemung Canal Plaza, P.O. Box 1522, Elmira, NY | 14902      |
| (Address of principal executive offices)           | (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 checked="" type="checkbox"/> | Smaller reporting company | <input 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 August 7, 2013 was 4,596,112.



CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES

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## PART I. FINANCIAL INFORMATION

## Item 1: Financial Statements-Unaudited

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
 CONSOLIDATED BALANCE SHEETS  
 (UNAUDITED)

|  | JUNE 30,<br>2013        | DECEMBER 31,<br>2012    |
|--|-------------------------|-------------------------|
| <b>ASSETS</b>  |                         |                         |
| Cash and due from financial institutions   | \$ 23,812,069           | \$ 29,239,309           |
| Interest-bearing deposits in other financial institutions  | 944,937                 | 11,001,912              |
| Total cash and cash equivalents  | 24,757,006              | 40,241,221              |
| Trading assets, at fair value  | 388,714                 | 348,241                 |
| Securities available for sale, at estimated fair value   | 225,361,952             | 239,685,763             |
| Securities held to maturity, estimated fair value of \$7,064,222 at June 30, 2013 and \$6,421,486 at December 31, 2012 | 6,570,262               | 5,748,453               |
| Federal Home Loan Bank and Federal Reserve Bank  |                         |                         |
| Stock, at cost   | 4,579,250               | 4,710,300               |
| Loans, net of deferred origination fees and costs, and unearned income   | 934,039,585             | 893,516,941             |
| Allowance for loan losses  | (11,320,225)            | (10,432,650)            |
| Loans, net   | 922,719,360             | 883,084,291             |
| Loans held for sale  | 947,461                 | 1,057,309               |
| Premises and equipment, net  | 24,968,834              | 25,484,385              |
| Goodwill   | 21,824,443              | 21,824,443              |
| Other intangible assets, net   | 4,694,741               | 5,143,820               |
| Bank owned life insurance  | 2,753,367               | 2,711,681               |
| Accrued interest receivable and other assets   | 17,595,097              | 18,119,801              |
| <b>Total assets</b>  | <b>\$ 1,257,160,487</b> | <b>\$ 1,248,159,708</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                         |                         |
| <b>Deposits:</b>   |                         |                         |
| Non-interest-bearing   | \$ 297,523,377          | \$ 300,610,463          |
| Interest-bearing   | 757,445,108             | 744,123,551             |
| Total deposits   | 1,054,968,485           | 1,044,734,014           |
| Securities sold under agreements to repurchase   | 30,568,070              | 32,710,650              |
| Federal Home Loan Bank term advances   | 26,101,230              | 27,225,363              |

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|  |                  |                  |
|--|------------------|------------------|
| Accrued interest payable and other liabilities   | 12,843,890       | 12,374,744       |
| Total liabilities  | 1,124,481,675    | 1,117,044,771    |
| Shareholders' equity:  |                  |                  |
| Common stock, \$.01 par value per share,<br>10,000,000<br>shares authorized; 5,310,076 issued at June<br>30, 2013<br>and December 31, 2012 | 53,101           | 53,101           |
| Additional-paid-in capital   | 45,450,561       | 45,357,073       |
| Retained earnings  | 109,755,452      | 107,078,182      |
| Treasury stock, at cost (713,964 shares at<br>June 30, 2013,<br>728,680 shares at December 31, 2012)                                       | (18,205,255)     | (18,566,490)     |
| Accumulated other comprehensive loss   | (4,375,047)      | (2,806,929)      |
| Total shareholders' equity   | 132,678,812      | 131,114,937      |
| Total liabilities and shareholders' equity   | \$ 1,257,160,487 | \$ 1,248,159,708 |

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,         | June 30,      | June 30,           | June 30,      |
|  | 2013             | 2012          | 2013               | 2012          |
| Interest and dividend income:                          |                  |               |                    |               |
| Loans, including fees                                  | \$ 22,360,424    | \$ 22,704,549 | \$ 11,056,416      | \$ 11,033,636 |
| Taxable securities                                     | 2,117,054        | 2,863,084     | 986,001            | 1,362,315     |
| Tax exempt securities                                  | 586,259          | 676,247       | 281,117            | 335,626       |
| Interest-bearing deposits                              | 17,691           | 60,777        | 9,708              | 33,413        |
| Total interest and dividend income                     | 25,081,428       | 26,304,657    | 12,333,242         | 12,764,990    |
| Interest expense:                                      |                  |               |                    |               |
| Deposits   | 1,218,610        | 1,726,994     | 594,529            | 814,345       |
| Securities sold under agreements to repurchase         | 430,801          | 532,300       | 211,452            | 249,528       |
| Borrowed funds   | 387,278          | 633,976       | 199,489            | 320,936       |
| Total interest expense                                 | 2,036,689        | 2,893,270     | 1,005,470          | 1,384,809     |
| Net interest income                                    | 23,044,739       | 23,411,387    | 11,327,772         | 11,380,181    |
| Provision for loan losses                              | 881,484          | 528,897       | 450,474            | 51,593        |
| Net interest income after provision for loan losses    | 22,163,255       | 22,882,490    | 10,877,298         | 11,328,588    |
| Other operating income:                                |                  |               |                    |               |
| Wealth management group fee income                     | 3,635,127        | 3,502,388     | 1,884,949          | 1,726,812     |
| Service charges on deposit accounts                    | 2,155,044        | 2,032,165     | 1,186,272          | 1,040,285     |
| Net gain on securities transactions                    | 1,228            | 299,919       | 1,228              | 2,750         |
| Net gain on sales of loans held for sale               | 291,169          | 144,380       | 179,253            | 79,041        |
| Casualty gains   | -                | 780,435       | -                  | 21,578        |
| Net gains (losses) on sales of other real estate owned | 15,997           | (4,502)       | 15,997             | 1,958         |
| Income from bank owned life insurance                  | 41,686           | 43,269        | 21,039             | 21,744        |
| Other  | 2,356,464        | 2,204,498     | 1,186,400          | 1,217,987     |
| Total other operating income                           | 8,496,715        | 9,002,552     | 4,475,138          | 4,112,155     |
| Other operating expenses:                              |                  |               |                    |               |
| Salaries and wages                                     | 9,416,991        | 9,048,726     | 4,598,762          | 4,556,051     |
|  | 2,788,999        | 2,756,477     | 1,364,523          | 1,466,537     |

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|                                      |              |              |              |              |
|--------------------------------------|--------------|--------------|--------------|--------------|
| Pension and other employee benefits  |              |              |              |              |
| Net occupancy expenses               | 2,700,996    | 2,580,009    | 1,339,411    | 1,285,131    |
| Furniture and equipment expenses     | 1,085,527    | 1,095,848    | 567,027      | 577,482      |
| Data processing expense              | 2,240,737    | 2,309,227    | 1,127,804    | 1,230,296    |
| Professional services                | 520,468      | 516,234      | 196,444      | 366,021      |
| Amortization of intangible assets    | 449,079      | 548,190      | 214,478      | 264,050      |
| Marketing and advertising expense    | 484,857      | 645,064      | 197,280      | 355,826      |
| Other real estate owned expenses     | 62,368       | 131,899      | 26,696       | 88,420       |
| FDIC insurance                       | 419,371      | 410,043      | 202,511      | 183,412      |
| Loan expense                         | 335,118      | 325,045      | 192,017      | 144,898      |
| Other                                | 2,611,750    | 2,445,879    | 1,364,551    | 1,363,297    |
| Total other operating expenses       | 23,116,261   | 22,812,641   | 11,391,504   | 11,881,421   |
| Income before income tax expense     | 7,543,709    | 9,072,401    | 3,960,932    | 3,559,322    |
| Income tax expense                   | 2,477,334    | 3,013,828    | 1,306,325    | 1,115,282    |
| Net income                           | \$ 5,066,375 | \$ 6,058,573 | \$ 2,654,607 | \$ 2,444,040 |
| Weighted average shares outstanding  | 4,657,131    | 4,639,204    | 4,658,400    | 4,636,395    |
| Basic and diluted earnings per share | \$ 1.09      | \$ 1.31      | \$ 0.57      | \$ 0.53      |

See accompanying notes to unaudited consolidated financial statements.



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

|   | Six Months Ended<br>June 30, |             | Three Months Ended<br>June 30, |             |
|---|------------------------------|-------------|--------------------------------|-------------|
|   | 2013                         | 2012        | 2013                           | 2012        |
| Net income  | \$ 5,066,375                 | \$6,058,573 | \$ 2,654,607                   | \$2,444,040 |
| Other comprehensive income  |                              |             |                                |             |
| Unrealized holding (losses) gains on securities available for sale              | (3,304,703)                  | 673,527     | (3,234,540)                    | 159,166     |
| Reclassification adjustment gains realized in net income                        | (1,228)                      | (299,919)   | (1,228)                        | (2,750)     |
| Net unrealized (losses) gains   | (3,305,931)                  | 373,608     | (3,235,768)                    | 156,416     |
| Tax effect  | (1,270,800)                  | 175,792     | (1,243,830)                    | 60,126      |
| Net of tax amount   | (2,035,131)                  | 197,816     | (1,991,938)                    | 96,290      |
| Change in funded status of defined benefit pension plan and other benefit plans |                              |             |                                |             |
| Reclassification adjustment for amortization of prior service costs             | (41,572)                     | (41,572)    | (20,786)                       | (20,786)    |
| Reclassification adjustment for amortization of net actuarial loss              | 801,086                      | 671,096     | 400,984                        | 335,548     |
| Total before tax effect   | 759,514                      | 629,524     | 380,198                        | 314,762     |
| Tax effect  | 292,501                      | 241,988     | 140,109                        | 120,994     |
| Net of tax amount   | 467,013                      | 387,536     | 240,089                        | 193,768     |
| Total other comprehensive (loss) income   | (1,568,118)                  | 585,352     | (1,751,849)                    | 290,058     |
| Comprehensive income  | \$ 3,498,257                 | \$6,643,925 | \$ 902,758                     | \$2,734,098 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(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<br>December 31, 2011   | \$ 53,101       | \$ 45,582,861                    | \$ 100,628,900       | \$ (18,894,044)   | \$ (1,441,378)  | \$ 125,929,440 |
| Net income   | -               | -                                | 6,058,573            | -                 | -   | 6,058,573      |
| Other<br>comprehensive<br>income   | -               | -                                | -                    | -                 | 585,352   | 585,352        |
| Restricted stock<br>awards   | -               | 44,743                           | -                    | -                 | -   | 44,743         |
| Restricted stock<br>units for directors'<br>deferred<br>compensation plan                          | -               | 42,982                           | -                    | -                 | -   | 42,982         |
| Cash dividends<br>declared (\$.50 per<br>share)  | -               | -                                | (2,286,005)          | -                 | -   | (2,286,005)    |
| Distribution of<br>10,238 shares of<br>treasury stock for<br>directors'<br>compensation            | -               | (28,121)                         | -                    | 261,069           | -   | 232,948        |
| Distribution of<br>3,453 shares of<br>treasury stock for<br>employee<br>compensation               | -               | (8,052)                          | -                    | 88,052            | -   | 80,000         |
| Distribution of<br>3,240 shares of<br>treasury stock for<br>deferred directors'<br>compensation    | -               | (81,747)                         | -                    | 82,588            | -   | 841            |
| Distribution of<br>1,079 shares of<br>treasury stock for<br>employee<br>restricted stock<br>awards | -               | (27,514)                         | -                    | 27,514            | -   | -              |
| Purchase of 19,098<br>shares of treasury<br>stock  | -               | -                                | -                    | (480,073)         | -   | (480,073)      |
| Balances at June 30,<br>2012   | \$ 53,101       | \$ 45,525,152                    | \$ 104,401,468       | \$ (18,914,894)   | \$ (856,026)  | \$ 130,208,801 |

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|                      |           |               |                |                 |                |                |
|----------------------|-----------|---------------|----------------|-----------------|----------------|----------------|
| Balances at          |           |               |                |                 |                |                |
| December 31, 2012    | \$ 53,101 | \$ 45,357,073 | \$ 107,078,182 | \$ (18,566,490) | \$ (2,806,929) | \$ 131,114,937 |
| Net income           | -         | -             | 5,066,375      | -               | -              | 5,066,375      |
| Other                |           |               |                |                 |                |                |
| comprehensive loss   | -         | -             | -              | -               | (1,568,118)    | (1,568,118)    |
| Restricted stock     |           |               |                |                 |                |                |
| awards               | -         | 85,494        | -              | -               | -              | 85,494         |
| Restricted stock     |           |               |                |                 |                |                |
| units for directors' |           |               |                |                 |                |                |
| deferred             |           |               |                |                 |                |                |
| compensation plan    | -         | 50,925        | -              | -               | -              | 50,925         |
| Cash dividends       |           |               |                |                 |                |                |
| declared (\$.52 per  |           |               |                |                 |                |                |
| share)               | -         | -             | (2,389,105)    | -               | -              | (2,389,105)    |
| Distribution of      |           |               |                |                 |                |                |
| 7,969 shares of      |           |               |                |                 |                |                |
| treasury stock for   |           |               |                |                 |                |                |
| directors'           |           |               |                |                 |                |                |
| compensation         | -         | 13,896        | -              | 203,050         | -              | 216,946        |
| Distribution of      |           |               |                |                 |                |                |
| 3,356 shares of      |           |               |                |                 |                |                |
| treasury stock for   |           |               |                |                 |                |                |
| deferred directors'  |           |               |                |                 |                |                |
| compensation         | -         | (74,623)      | -              | 85,577          | -              | 10,954         |
| Distribution of      |           |               |                |                 |                |                |
| 4,116 shares of      |           |               |                |                 |                |                |
| treasury stock for   |           |               |                |                 |                |                |
| employee             |           |               |                |                 |                |                |
| compensation         | -         | 7,278         | -              | 104,876         | -              | 112,154        |
| Purchase of 3,094    |           |               |                |                 |                |                |
| shares of treasury   |           |               |                |                 |                |                |
| stock                | -         | -             | -              | (92,630)        | -              | (92,630)       |
| Sale of 2,369 shares |           |               |                |                 |                |                |
| of treasury stock    | -         | 10,518        | -              | 60,362          | -              | 70,880         |
| Balances at June 30, |           |               |                |                 |                |                |
| 2013                 | \$ 53,101 | \$ 45,450,561 | \$ 109,755,452 | \$ (18,205,255) | \$ (4,375,047) | \$ 132,678,812 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
SIX MONTHS ENDED  
JUNE 30,

| CASH FLOWS FROM OPERATING ACTIVITIES:  | 2013          | 2012         |
|--|---------------|--------------|
| Net income   | \$ 5,066,375  | \$ 6,058,573 |
| Adjustments to reconcile net income to net cash provided<br>by operating activities:   |               |              |
| Amortization of intangible assets  | 449,079       | 548,190      |
| Provision for loan losses  | 881,484       | 528,897      |
| Depreciation and amortization of fixed assets  | 1,513,066     | 1,497,490    |
| Amortization of premiums on securities, net  | 1,125,431     | 894,292      |
| Gains on sales of loans held for sale, net   | (291,169)     | (144,380)    |
| Proceeds from sales of loans held for sale   | 9,470,394     | 5,360,780    |
| Loans originated and held for sale   | (9,069,377)   | (5,303,317)  |
| Net gains on trading assets  | (13,098)      | (17,369)     |
| Net gains on securities transactions   | (1,228)       | (299,919)    |
| Proceeds from sales of trading assets  | 4,938         | 92,584       |
| Purchase of trading assets   | (32,313)      | (32,939)     |
| Net (gains) losses on sale of other real estate owned                                  | (15,997)      | 4,502        |
| (Increase) decrease in other assets  | (1,421,591)   | 4,919,260    |
| Decrease in prepaid FDIC assessment  | 1,969,526     | 372,601      |
| Decrease in accrued interest payable   | (48,142)      | (144,225)    |
| Expense related to restricted stock units for directors'<br>deferred compensation plan | 50,925        | 42,982       |
| Expense related to employee stock compensation   | 112,154       | 80,000       |
| Expense related to employee stock awards   | 85,494        | 44,743       |
| Increase (decrease) in other liabilities   | 1,298,530     | (104,425)    |
| Income from bank owned life insurance  | (41,686)      | (43,269)     |
| Net cash provided by operating activities  | 11,092,795    | 14,355,051   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |               |              |
| Proceeds from sales and calls of securities available for sale                         | 10,533,633    | 69,367,438   |
| Proceeds from maturities and principal collected on securities<br>available for sale   | 31,120,375    | 14,616,579   |
| Proceeds from maturities and principal collected on securities<br>held to maturity     | 3,908,091     | 3,518,840    |
| Purchases of securities available for sale   | (31,760,331)  | (64,276,418) |
| Purchases of securities held to maturity   | (4,729,900)   | (1,541,250)  |
| Purchase of Federal Home Loan Bank and Federal Reserve Bank<br>stock                   | (2,930,350)   | (26,250)     |
| Redemption of Federal Home Loan Bank and Federal Reserve<br>Bank stock                 | 3,061,400     | 176,900      |
| Purchases of premises and equipment  | (997,515)     | (1,452,526)  |
| Proceeds from sales of other real estate owned   | 87,737        | 132,273      |
| Net increase in loans  | (40,611,523)  | (58,445,477) |
| Net cash used by investing activities  | (32,318,383 ) | (37,929,891) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |               |              |

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|   |               |               |
|---|---------------|---------------|
| Net increase in demand deposits, interest-bearing demand accounts,<br>savings accounts, and insured money market accounts | 21,959,430    | 72,097,856    |
| Net decrease in time deposits   | (11,724,959)  | (16,911,987)  |
| Net decrease in securities sold under agreements to repurchase  | (2,142,580)   | (5,356,414)   |
| Repayments of Federal Home Loan Bank long term advances   | (1,124,133)   | (2,216,124)   |
| Purchase of treasury stock  | (92,630)      | (480,073)     |
| Sale of treasury stock  | 60,362        | -             |
| Cash dividends paid   | (1,194,117)   | (2,285,005)   |
| Net cash provided by financing activities   | 5,741,373     | 44,848,253    |
| Net (decrease) increase in cash and cash equivalents  | (15,484,215)  | 21,273,413    |
| Cash and cash equivalents, beginning of period  | 40,241,221    | 52,901,853    |
| Cash and cash equivalents, end of period  | \$ 24,757,006 | \$ 74,175,266 |

(continued)

Supplemental disclosure of cash flow information:

Cash paid during the year for:

|              |              |              |
|--------------|--------------|--------------|
| Interest     | \$ 2,084,831 | \$ 3,068,390 |
| Income Taxes | \$ 2,591,049 | \$ 3,500     |

Supplemental disclosure of non-cash activity:

|  |              |              |
|--|--------------|--------------|
| Transfer of loans to other real estate owned | \$ 94,970    | \$ 223,071   |
| Dividends declared, not yet paid             | \$ 1,194,988 | \$ 1,142,082 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

To assist the reader, the Corporation has provided the following list of commonly used acronyms and abbreviations included in the Notes to Unaudited Consolidated Financial Statements.

|   |   |
|---|---|
| FASB: Financial Accounting Standards Board          | OTTI: Other-than-temporary impairment   |
| FDIC: Federal Deposit Insurance Corporation         | PCI: Purchased credit impaired          |
| FHLB: Federal Home Loan Bank                        | SEC: Securities and Exchange Commission |
| GAAP: U.S. generally accepted accounting principles | CDO: Collateralized Debt Obligation     |

Organization and Principles of Consolidation

Chemung Financial Corporation (the “Corporation”) is a bank holding company headquartered in Elmira, New York. The Corporation provides a wide range of financial and fiduciary services through its wholly-owned subsidiaries, Chemung Canal Trust Company (the “Bank”), a state chartered bank, and CFS Group, Inc., a non-bank financial services company. The Corporation and the Bank are subject to the regulation of certain federal and state agencies and undergo periodic examinations by those regulatory authorities. The unaudited consolidated financial statements include the accounts of the Corporation, the Bank and CFS Group, Inc. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications of prior period amounts have been made to conform with the current period presentation. These reclassifications had no impact on previously reported net income.

Basis of Presentation

The unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the SEC in Article 10 of Regulation S-X and in accordance with the instructions to Form 10-Q and GAAP for interim financial information. Certain information, accounting policies and footnote disclosures normally included in complete financial statements prepared in accordance with GAAP have been condensed or omitted in accordance with such rules and regulations. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation’s annual report on Form 10-K for the year ended December 31, 2012.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the unaudited consolidated financial statements and accompanying notes. Primary areas involving the use of estimates and assumptions include the allowance for loan losses, other-than-temporary impairment of securities, the carrying amount of goodwill and the amortization of other intangible assets. Actual results could differ from those estimates. In the opinion of management, all adjustments considered necessary, consisting of normal recurring items, have been included for a fair presentation of the accompanying unaudited consolidated financial statements. Operating results for the three and six months ended June 30, 2013 are not necessarily indicative of the results that may be expected for the full year or future periods.

Subsequent Events

The Corporation has evaluated events and transactions through the time the unaudited consolidated financial statements were issued. Financial statements are considered issued when they are widely distributed to all shareholders and other financial statement users, or filed with the SEC. In conjunction with applicable accounting standards, all material subsequent events have been either recognized in the unaudited consolidated financial statements or disclosed in the notes to the unaudited consolidated financial statements.



## NOTE 2 EARNING 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. All outstanding unvested share based payment awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation. Restricted stock awards 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 4,657,131 and 4,639,204 weighted average shares outstanding for the six-month periods ended June 30, 2013 and 2012, and 4,658,400 and 4,636,395 weighted average shares outstanding for the three-month periods ended June 30, 2013 and 2012, respectively. There were no dilutive common stock equivalents during the three or six-month periods ended June 30, 2013 or 2012.

## NOTE 3 ADOPTION OF NEW ACCOUNTING STANDARDS

In February 2013, the FASB issued Accounting Standards Update ("ASU") No. 2013-02, "Comprehensive Income (Topic 220) – Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." ASU 2013-02 amends recent guidance related to the reporting of comprehensive income to enhance the transparency of the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 became effective for the Corporation on January 1, 2013 and did not have a material impact on the Corporation's financial statements. The additional disclosures are included in Note 8 Accumulated Other Comprehensive Income or Loss.

## NOTE 4 SECURITIES

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

|   | June 30, 2013     |                     |                      |                         |
|---|-------------------|---------------------|----------------------|-------------------------|
|   | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Estimated Fair<br>Value |
| Obligations of U.S.<br>Government and U.S.<br>Government sponsored<br>enterprises | \$ 143,415,030    | \$ 1,854,458        | \$ 819,118           | \$ 144,450,370          |
| Mortgage-backed securities,<br>residential  | 21,869,811        | 1,109,754           | 173                  | 22,979,392              |
| Collateralized mortgage<br>obligations  | 2,166,314         | 22,661              | -                    | 2,188,975               |
| Obligations of states and<br>political subdivisions                               | 36,005,029        | 1,006,738           | 8,204                | 37,003,563              |
| Corporate bonds and notes   | 7,401,318         | 119,787             | 5,532                | 7,515,573               |
| SBA loan pools  | 1,554,691         | 37,220              | -                    | 1,591,911               |
| Trust Preferred securities  | 2,523,193         | 107,238             | 114,725              | 2,515,706               |
| Corporate stocks  | 700,024           | 6,418,407           | 1,969                | 7,116,462               |
| Total   | \$ 215,635,410    | \$ 10,676,263       | \$ 949,721           | \$ 225,361,952          |

|  | December 31, 2012 |                  |                   |                      |
|--|-------------------|------------------|-------------------|----------------------|
|  | Amortized Cost    | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Obligations of U.S. Government and U.S.          |                   |                  |                   |                      |
| Government sponsored enterprises                 | \$ 138,041,393    | \$ 3,549,821     | \$ -              | \$ 141,591,214       |
| Mortgage-backed securities, residential          | 29,591,883        | 1,923,366        | -                 | 31,515,249           |
| Collateralized mortgage obligations              | 3,494,642         | 48,718           | -                 | 3,543,360            |
| Obligations of states and political subdivisions | 39,174,595        | 1,641,510        | 1,383             | 40,814,722           |
| Corporate bonds and notes                        | 11,412,167        | 239,468          | -                 | 11,651,635           |
| SBA loan pools                                   | 1,682,736         | 41,404           | -                 | 1,724,140            |
| Trust preferred securities                       | 2,519,379         | 134,959          | 183,425           | 2,470,913            |
| Corporate stocks                                 | 736,495           | 5,645,753        | 7,718             | 6,374,530            |
| Total  | \$ 226,653,290    | \$ 13,224,999    | \$ 192,526        | \$ 239,685,763       |

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

|  | June 30, 2013       |                   |                   |                      |
|--|---------------------|-------------------|-------------------|----------------------|
|  | Amortized Cost      | Unrealized Gains  | Unrealized Losses | Estimated Fair Value |
| Obligations of states and political subdivisions | \$ 4,289,745        | \$ 469,783        | \$ -              | \$ 4,759,528         |
| Time deposits with other financial institutions  | 2,280,517           | 24,177            | -                 | 2,304,694            |
| <b>Total</b>                                     | <b>\$ 6,570,262</b> | <b>\$ 493,960</b> | <b>\$ -</b>       | <b>\$ 7,064,222</b>  |

|  | December 31, 2012 |                  |                   |                      |
|--|-------------------|------------------|-------------------|----------------------|
|  | Amortized Cost    | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Obligations of states and political subdivisions | \$ 5,748,453      | \$ 673,033       | \$ -              | \$ 6,421,486         |

The amortized cost and estimated fair value of debt securities are shown below 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. Securities not due at a single maturity date are shown separately:

|   | June 30, 2013         |                       |                     |                     |
|---|-----------------------|-----------------------|---------------------|---------------------|
|   | Available for Sale    |                       | Held to Maturity    |                     |
|   | Amortized Cost        | Fair Value            | Amortized Cost      | Fair Value          |
| Within One Year                         | \$ 19,976,974         | \$ 20,169,545         | \$ 2,126,042        | \$ 2,147,424        |
| After One, But Within Five Years        | 151,074,813           | 153,060,997           | 3,037,881           | 3,266,532           |
| After Five, But Within Ten Years        | 16,717,345            | 16,756,465            | 1,406,339           | 1,650,266           |
| After Ten Years                         | 1,575,438             | 1,498,205             | -                   | -                   |
|   | 189,344,570           | 191,485,212           | 6,570,262           | 7,064,222           |
| Mortgage-backed securities, residential | 21,869,811            | 22,979,392            | -                   | -                   |
| Collateralized mortgage obligations     | 2,166,314             | 2,188,975             | -                   | -                   |
| SBA loan pools                          | 1,554,691             | 1,591,911             | -                   | -                   |
| <b>Total</b>                            | <b>\$ 214,935,386</b> | <b>\$ 218,245,490</b> | <b>\$ 6,570,262</b> | <b>\$ 7,064,222</b> |

The proceeds from sales and calls of securities resulting in gains or losses at June 30, 2013 and June 30, 2012 are listed below:

|              | 2013          | 2012          |
|--------------|---------------|---------------|
| Proceeds     | \$ 10,533,633 | \$ 69,367,438 |
| Gross gains  | \$ 1,228      | \$ 299,919    |
| Gross losses | \$ -          | \$ -          |

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Tax expense \$ 472 \$ 115,289

The following tables summarize the investment securities available for sale with unrealized losses at June 30, 2013 and December 31, 2012 by aggregated major security type and length of time in a continuous unrealized loss position:

| June 30, 2013  | 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 U.S. Government sponsored enterprises | \$ 61,720,950       | \$ 819,118        | \$ -                | \$ -              | \$ 61,720,950 | \$ 819,118        |
| Mortgage-backed securities, residential                                  | 114,557             | 173               | -                   | -                 | 114,557       | 173               |
| Obligations of states and political subdivisions                         | 946,089             | 7,630             | 250,673             | 574               | 1,196,762     | 8,204             |
| Corporate bonds  | 240,667             | 5,532             | -                   | -                 | 240,667       | 5,532             |
| Trust preferred securities   | -                   | -                 | 514,300             | 114,725           | 514,300       | 114,725           |
| Corporate stocks   | -                   | -                 | 1,668               | 1,969             | 1,668         | 1,969             |
| Total temporarily impaired securities                                    | \$ 63,022,263       | \$ 832,453        | \$ 766,641          | \$ 117,268        | \$ 63,788,904 | \$ 949,721        |

| December 31,<br>2012                                      | Less than 12 months |                      | 12 months or longer |                      | Total      |                      |
|---|---------------------|----------------------|---------------------|----------------------|------------|----------------------|
|   | Fair Value          | Unrealized<br>Losses | Fair Value          | Unrealized<br>Losses | Fair Value | Unrealized<br>Losses |
| Obligations of<br>states and<br>political<br>subdivisions | \$ -                | \$ -                 | \$430,166           | \$ 1,383             | \$430,166  | \$ 1,383             |
| Trust preferred<br>securities                             | -                   | -                    | 445,600             | 183,425              | 445,600    | 183,425              |
| Corporate stocks  | -                   | -                    | 45,912              | 7,718                | 45,912     | 7,718                |
| Total<br>temporarily<br>impaired<br>securities            | \$ -                | \$ -                 | \$921,678           | \$192,526            | \$921,678  | \$192,526            |

#### Other-Than-Temporary Impairment

As of June 30, 2013, the majority of the Corporation's unrealized losses in the investment securities portfolio related to obligations of U.S. Government and U.S. Government sponsored enterprises. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Corporation does not have the intent to sell these securities and it is likely that it will not be required to sell these securities before their anticipated recovery, the Corporation does not consider these securities to be other-than-temporarily impaired at June 30, 2013.

As of June 30, 2013, \$114,725 of the Corporation's unrealized losses in the investment securities portfolio related to a CDO consisting of a pool of trust preferred securities. The decline in fair value on this security 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 this security. This fact combined with the current illiquidity in the market makes it unlikely that the Corporation would be able to recover its investment in this security if it was sold at this time.

Our analysis of this investment includes a \$629,025 amortized cost of a CDO consisting of a pool of trust preferred securities. This security was rated high quality at inception, but at June 30, 2013 Moody's rated this security 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 each 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.

Upon completion of the June 30, 2013 analysis, our model indicated no additional OTTI on this CDO. This security remained classified as available for sale and quarterly interest payments continue to be made.

When conducting the June 30, 2013 analysis, 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. The analysis indicated no further decline in value attributed to credit related factors stemming from further deterioration in the underlying collateral payment streams. Additionally, to estimate fair value 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 security based on current market conditions and interest rates. 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 OTTI recognized in accumulated other comprehensive income was \$74,482 and \$190,833, net of tax for securities available for sale at June 30, 2013 and 2012, respectively.

The tables below present a roll forward of the cumulative credit losses recognized in earnings for the three and six-month periods ending June 30, 2013 and 2012:

|  | 2013         | 2012         |
|--|--------------|--------------|
| Beginning balance, January 1,  | \$ 3,506,073 | \$ 3,506,073 |
| 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 | -            | -            |
| Ending balance, June 30,   | \$ 3,506,073 | \$ 3,506,073 |

|  |              |              |
|--|--------------|--------------|
| Beginning balance, April 1,  | \$ 3,506,073 | \$ 3,506,073 |
| 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 | -            | -            |
| Ending balance, June 30,   | \$ 3,506,073 | \$ 3,506,073 |

NOTE 5                      LOANS AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio, net of deferred origination fees and cost, and unearned income is summarized as follows:

|                              | June 30, 2013 | December 31, 2012 |
|------------------------------|---------------|-------------------|
| Commercial and agricultural: |               |                   |

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|  |                |                |
|--|----------------|----------------|
| Commercial and industrial  | \$ 134,617,505 | \$ 133,154,615 |
| Agricultural   | 711,904        | 696,666        |
| Commercial mortgages:  |                |                |
| Construction   | 19,275,080     | 43,269,303     |
| Other  | 323,413,353    | 276,928,123    |
| Residential mortgages  | 198,071,941    | 200,475,097    |
| Consumer loans:  |                |                |
| Credit cards   | 1,680,116      | 1,851,145      |
| Home equity lines and loans  | 90,494,092     | 87,045,421     |
| Indirect consumer loans  | 146,624,572    | 130,573,200    |
| Direct consumer loans  | 19,151,022     | 19,523,371     |
| Total loans, net of deferred origination fees and costs, and unearned income | 934,039,585    | \$ 893,516,941 |
| Interest receivable on loans   | 2,389,020      | 2,383,998      |
| Total recorded investment in loans   | \$ 936,428,605 | \$ 895,900,939 |

The Corporation's concentrations of credit risk by loan type are reflected in the preceding table. The concentrations of credit risk with standby letters of credit, committed lines of credit and commitments to originate new loans generally follow the loan classifications in the table above.



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The following tables present the activity in the allowance for loan losses by portfolio segment for the three and six-month periods ending June 30, 2013 and 2012:

| Six Months Ended<br>June 30, 2013  |                                   |                         |                          |                   |             |               |
|------------------------------------|-----------------------------------|-------------------------|--------------------------|-------------------|-------------|---------------|
| Allowance for<br>loan losses       | Commercial<br>and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Mortgages | Consumer<br>Loans | Unallocated | Total         |
| Beginning<br>balance:              | \$ 1,707,596                      | \$ 4,427,698            | \$ 1,565,571             | \$ 2,705,639      | \$ 26,146   | \$ 10,432,650 |
| Charge Offs:                       | (18,475)                          | -                       | (53,753)                 | (397,783)         | -           | (470,011)     |
| Recoveries:                        | 294,696                           | 19,276                  | 38,610                   | 123,520           | -           | 476,102       |
| Net<br>recoveries<br>(charge offs) | 276,221                           | 19,276                  | (15,143)                 | (274,263)         | -           | 6,091         |
| Provision                          | (105,120)                         | 687,436                 | (35,004)                 | 360,318           | (26,146)    | 881,484       |
| Ending balance                     | \$ 1,878,697                      | \$ 5,134,410            | \$ 1,515,424             | \$ 2,791,694      | \$ -        | \$ 11,320,225 |

| Six Months Ended<br>June 30, 2012                |                                   |                         |                          |                   |             |               |
|--|-----------------------------------|-------------------------|--------------------------|-------------------|-------------|---------------|
| Allowance for<br>loan losses                     | Commercial<br>and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Mortgages | Consumer<br>Loans | Unallocated | Total         |
| Beginning<br>balance:                            | \$ 3,143,372                      | \$ 2,570,149            | \$ 1,309,649             | \$ 2,192,729      | \$ 443,420  | \$ 9,659,319  |
| Reclassification<br>of acquired<br>loan discount | 73,227                            | 50,332                  | -                        | -                 | -           | 123,559       |
| Charge Offs:                                     | (5,792)                           | (57,352)                | (72,613)                 | (273,428)         | -           | (409,185)     |
| Recoveries:                                      | 351,763                           | 30,496                  | -                        | 107,723           | -           | 489,982       |
| Net recoveries<br>(charge-offs)                  | 345,971                           | (26,856)                | (72,613)                 | (165,705)         | -           | 80,797        |
| Provision  | (558,359)                         | 482,087                 | 187,780                  | 447,161           | \$ (29,772) | 528,897       |
| Ending balance                                   | \$ 3,004,211                      | \$ 3,075,712            | \$ 1,424,816             | \$ 2,474,185      | \$ 413,648  | \$ 10,392,572 |

| Three Months Ended<br>June 30, 2013 |                                   |                         |                          |                   |             |               |
|-------------------------------------|-----------------------------------|-------------------------|--------------------------|-------------------|-------------|---------------|
| Allowance for<br>loan losses        | Commercial<br>and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Mortgages | Consumer<br>Loans | Unallocated | Total         |
| Beginning<br>balance:               | \$ 1,992,884                      | \$ 4,672,637            | \$ 1,557,098             | \$ 2,602,074      | \$ -        | \$ 10,824,693 |
| Charge Offs:                        | (1,863)                           | -                       | (9,393)                  | (200,419)         | -           | (211,675)     |
| Recoveries:                         | 152,271                           | 10,301                  | 38,610                   | 55,551            | -           | 256,733       |
| Net recoveries<br>(charge offs)     | 150,408                           | 10,301                  | 29,217                   | (144,868)         | -           | 45,058        |
| Provision                           | (264,595)                         | 451,472                 | (70,891)                 | 334,488           | -           | 450,474       |

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Ending balance    \$ 1,878,697    \$ 5,134,410    \$ 1,515,424    \$ 2,791,694    \$ -    \$ 11,320,225

| Allowance for<br>loan losses       | Three Months Ended<br>June 30, 2012 |                         |                          |                   |            | Unallocated   | Total |
|------------------------------------|-------------------------------------|-------------------------|--------------------------|-------------------|------------|---------------|-------|
|                                    | Commercial and<br>Agricultural      | Commercial<br>Mortgages | Residential<br>Mortgages | Consumer<br>Loans |            |               |       |
| Beginning<br>balance:              | \$ 3,361,393                        | \$ 3,030,504            | \$ 1,417,252             | \$ 2,100,433      | \$ 373,708 | \$ 10,283,290 |       |
| Charge Offs:                       | (5,792)                             | (8,295)                 | (58,273)                 | (115,109)         | -          | (187,469)     |       |
| Recoveries:                        | 179,156                             | 20,261                  | -                        | 45,741            | -          | 245,158       |       |
| Net<br>recoveries<br>(charge offs) | 173,364                             | 11,966                  | (58,273)                 | (69,368)          | -          | 57,689        |       |
| Provision                          | (530,546)                           | 33,242                  | 65,837                   | 443,120           | 39,940     | 51,593        |       |
| Ending balance                     | \$ 3,004,211                        | \$ 3,075,712            | \$ 1,424,816             | \$ 2,474,185      | \$ 413,648 | \$ 10,392,572 |       |

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The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of June 30, 2013 and December 31, 2012:

| Allowance for<br>loan losses<br>Ending<br>allowance<br>balance<br>attributable to<br>loans: | June 30, 2013                  |                         |                          |                   |             | Total         |
|---|--------------------------------|-------------------------|--------------------------|-------------------|-------------|---------------|
|   | Commercial and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Mortgages | Consumer<br>Loans | Unallocated |               |
| Individually<br>evaluated for<br>Impairment   | \$ 315,962                     | \$ 450,245              | \$ -                     | \$ 4,020          | \$ -        | \$ 770,227    |
| Collectively<br>evaluated for<br>impairment   | 1,395,165                      | 3,828,486               | 1,495,747                | 2,787,674         | -           | 9,507,072     |
| Acquired with<br>deteriorated<br>credit quality   | 167,570                        | 855,679                 | 19,677                   | -                 | -           | 1,042,926     |
| Total ending<br>allowance<br>balance  | \$ 1,878,697                   | \$ 5,134,410            | \$ 1,515,424             | \$ 2,791,694      | \$ -        | \$ 11,320,225 |

| Allowance for<br>loan losses<br>Ending<br>allowance<br>balance<br>attributable to<br>loans: | December 31, 2012              |                         |                          |                   |             | Total         |
|---|--------------------------------|-------------------------|--------------------------|-------------------|-------------|---------------|
|   | Commercial and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Mortgages | Consumer<br>Loans | Unallocated |               |
| Individually<br>evaluated for<br>impairment   | \$ 133,437                     | \$ 59,201               | \$ -                     | \$ -              | \$ -        | \$ 192,638    |
| Collectively<br>evaluated for<br>impairment   | 1,459,432                      | 3,533,365               | 1,565,571                | 2,705,639         | 26,146      | 9,290,153     |
| Acquired with<br>deteriorated<br>credit quality   | 114,727                        | 835,132                 | -                        | -                 | -           | 949,859       |
| Total ending<br>allowance<br>balance  | \$ 1,707,596                   | \$ 4,427,698            | \$ 1,565,571             | \$ 2,705,639      | \$ 26,146   | \$ 10,432,650 |

| Loans: | June 30, 2013     |                         |                          |                   | Total |
|--------|-------------------|-------------------------|--------------------------|-------------------|-------|
|        | Commercial<br>and | Commercial<br>Mortgages | Residential<br>Mortgages | Consumer<br>Loans |       |
|        |                   |                         |                          |                   |       |

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Agricultural

|   |                |                |                |                |                |
|---|----------------|----------------|----------------|----------------|----------------|
| Loans individually evaluated for impairment     | \$ 2,227,900   | \$ 9,945,029   | \$ 125,420     | \$ 102,914     | \$ 12,401,263  |
| Loans collectively evaluated for impairment     | 132,554,915    | 324,521,166    | 198,223,145    | 258,518,832    | 913,818,058    |
| Loans acquired with deteriorated credit quality | 882,814        | 9,073,632      | 252,838        | -              | 10,209,284     |
| Total ending loans balance                      | \$ 135,665,629 | \$ 343,539,827 | \$ 198,601,403 | \$ 258,621,746 | \$ 936,428,605 |

December 31, 2012

| Loans:  | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total          |
|---|-----------------------------|----------------------|-----------------------|----------------|----------------|
| Loans individually evaluated for impairment     | \$ 1,907,395                | \$ 10,620,274        | \$ 131,909            | \$ -           | \$ 12,659,578  |
| Loans collectively evaluated for impairment     | 131,045,609                 | 301,172,164          | 200,622,600           | 239,689,455    | 872,529,828    |
| Loans acquired with deteriorated credit quality | 1,241,418                   | 9,225,847            | 244,268               | -              | 10,711,533     |
| Total ending loans balance                      | \$ 134,194,422              | \$ 321,018,285       | \$ 200,998,777        | \$ 239,689,455 | \$ 895,900,939 |

The following tables present loans individually evaluated for impairment recognized by class of loans as of June 30, 2013 and December 31, 2012, the average recorded investment and interest income recognized by class of loans as of the three and six-month periods ending June 30, 2013 and 2012:

|                                     | June 30, 2013            |                      |                                     | December 31, 2012        |                      |                                     |
|-------------------------------------|--------------------------|----------------------|-------------------------------------|--------------------------|----------------------|-------------------------------------|
|                                     | Unpaid Principal Balance | Recorded Investment  | Allowance for Loan Losses Allocated | Unpaid Principal Balance | Recorded Investment  | Allowance for Loan Losses Allocated |
| With no related allowance recorded: |                          |                      |                                     |                          |                      |                                     |
| Commercial and agricultural:        |                          |                      |                                     |                          |                      |                                     |
| Commercial & industrial             | \$ 1,852,772             | \$ 1,655,206         | \$ -                                | \$ 2,059,027             | \$ 1,462,157         | \$ -                                |
| Commercial mortgages:               |                          |                      |                                     |                          |                      |                                     |
| Construction                        | 3,177,618                | 3,154,238            | -                                   | 5,168,353                | 5,166,853            | -                                   |
| Other                               | 6,031,853                | 5,669,704            | -                                   | 5,678,565                | 5,090,399            | -                                   |
| Residential mortgages               | 125,420                  | 125,420              | -                                   | 131,909                  | 131,909              | -                                   |
| Consumer loans:                     |                          |                      |                                     |                          |                      |                                     |
| Home equity lines & loans           | 43,975                   | 44,772               | -                                   | -                        | -                    | -                                   |
| With an allowance recorded:         |                          |                      |                                     |                          |                      |                                     |
| Commercial and agricultural:        |                          |                      |                                     |                          |                      |                                     |
| Commercial & industrial             | 972,894                  | 572,694              | 315,962                             | 446,330                  | 445,238              | 133,437                             |
| Commercial mortgages:               |                          |                      |                                     |                          |                      |                                     |
| Other                               | 1,130,969                | 1,121,087            | 450,245                             | 364,423                  | 363,022              | 59,201                              |
| Consumer loans:                     |                          |                      |                                     |                          |                      |                                     |
| Home equity lines & loans           | 57,876                   | 58,142               | 4,020                               | -                        | -                    | -                                   |
| <b>Total</b>                        | <b>\$ 13,393,377</b>     | <b>\$ 12,401,263</b> | <b>\$ 770,227</b>                   | <b>\$ 13,848,607</b>     | <b>\$ 12,659,578</b> | <b>\$ 192,638</b>                   |

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|  | Six-Months Ended<br>June 30, 2013 |                                  | Six-Months Ended<br>June 30, 2012 |                                  | Three Months Ended<br>June 30, 2013 |                                  | Three Months<br>Ended<br>June 30, 2012 |                                  |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|-------------------------------------|----------------------------------|--|----------------------------------|
|  | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment   | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment      | Interest<br>Income<br>Recognized |
| With no<br>related<br>allowance<br>recorded:<br>Commercial<br>and<br>agricultural: |                                   |                                  |                                   |                                  |                                     |                                  |  |                                  |
| Commercial<br>& industrial   | \$ 1,523,566                      | \$ 34,558                        | \$ 1,067,170                      | \$ -                             | \$ 1,554,270                        | \$ 17,407                        | \$ 143,367                             | \$ -                             |
| Commercial<br>mortgages:   |                                   |                                  |                                   |                                  |                                     |                                  |  |                                  |
| Construction   | 4,168,038                         | 63,924                           | 10,454                            | -                                | 3,668,630                           | 32,132                           | 10,454                                 | -                                |
| Other  | 5,685,324                         | 118,310                          | 827,553                           | -                                | 5,982,787                           | 65,768                           | 811,005                                | -                                |
| Residential<br>mortgages   | 128,559                           | -                                | 111,368                           | -                                | 126,884                             | -                                | 77,384                                 | -                                |
| Consumer<br>loans:   |                                   |                                  |                                   |                                  |                                     |                                  |  |                                  |
| Home equity<br>lines & loans   | 30,104                            | 681                              | 19,856                            | 2,289                            | 45,156                              | 428                              | 29,784                                 | 1,123                            |
| With an<br>allowance<br>recorded:<br>Commercial<br>and<br>agricultural:            |                                   |                                  |                                   |                                  |                                     |                                  |  |                                  |
| Commercial<br>& industrial   | 498,852                           | -                                | 2,347,963                         | -                                | 525,660                             | -                                | 2,341,810                              | -                                |
| Commercial<br>mortgages:   |                                   |                                  |                                   |                                  |                                     |                                  |  |                                  |
| Construction   | -                                 | -                                | 5,530                             | -                                | -                                   | -                                | 4,148                                  | -                                |
| Other  | 614,402                           | -                                | 2,109,919                         | -                                | 740,092                             | -                                | 1,302,796                              | -                                |
| Residential<br>mortgages   | -                                 | -                                | 42,668                            | -                                | -                                   | -                                | -                                      | -                                |
| Consumer<br>loans:   |                                   |                                  |                                   |                                  |                                     |                                  |  |                                  |
| Home equity<br>lines & loans   | 38,730                            | 1,249                            | -                                 | -                                | 58,094                              | 1,082                            | -                                      | -                                |
| Direct<br>consumer<br>loans  | 5,083                             | -                                | -                                 | -                                | 7,625                               | -                                | -                                      | -                                |
| Total  | \$ 12,692,658                     | \$ 218,722                       | \$ 6,542,481                      | \$ 2,289                         | \$ 12,709,198                       | \$ 116,817                       | \$ 4,720,748                           | \$ 1,123                         |

(1) Cash basis interest income approximates interest income recognized.



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The following tables present the recorded investment in past due and non-accrual status by class of loans as of June 30, 2013 and December 31, 2012:

| June 30, 2013                | Current     | 30-89 Days<br>Past Due | 90 Days or<br>more Past<br>Due and<br>accruing | Loans<br>acquired<br>with<br>deteriorated<br>credit<br>quality | Non-Accrual (1) | Total          |
|------------------------------|-------------|------------------------|--|--|-----------------|----------------|
| Commercial and agricultural: |             |                        |  |  |                 |                |
| Commercial & industrial      | 132,448,955 | \$ 679,194             | \$ -   | \$ 882,814   | \$ 940,993      | \$ 134,951,956 |
| Agricultural                 | 713,673     | -                      | -  | -  | -               | 713,673        |
| Commercial mortgages:        |             |                        |  |  |                 |                |
| Construction                 | 15,076,034  | -                      | 2,183,858                                      | 1,092,697  | 970,380         | 19,322,969     |
| Other                        | 313,754,610 | 545,878                | -  | 7,980,935  | 1,935,435       | 324,216,858    |
| Residential mortgages        | 193,556,426 | 1,987,955              | -  | 252,838  | 2,804,184       | 198,601,403    |
| Consumer loans:              |             |                        |  |  |                 |                |
| Credit cards                 | 1,653,581   | 10,798                 | 15,737   | -  | -               | 1,680,116      |
| Home equity lines & loans    | 89,954,325  | 296,430                | -  | -  | 475,671         | 90,726,426     |
| Indirect consumer loans      | 145,819,447 | 896,746                | -  | -  | 280,817         | 146,997,010    |
| Direct consumer loans        | 19,093,867  | 63,451                 | -  | -  | 60,876          | 19,218,194     |
| Total                        | 912,070,918 | \$4,480,452            | \$2,199,595                                    | \$ 10,209,284  | \$ 7,468,356    | \$936,428,605  |

(1) Includes all loans on non-accrual status regardless of the number of days such loans were delinquent as of June 30, 2013.

| December 31, 2012            | Current     | 30-89 Days<br>Past Due | 90 Days or<br>more Past<br>Due and<br>accruing | Loans<br>acquired<br>with<br>deteriorated<br>credit<br>quality | Non-Accrual (1) | Total          |
|------------------------------|-------------|------------------------|--|--|-----------------|----------------|
| Commercial and agricultural: |             |                        |  |  |                 |                |
| Commercial & industrial      | 131,404,371 | \$ 183,269             | \$ -   | \$ 1,241,418   | \$ 666,912      | \$ 133,495,970 |
| Agricultural                 | 698,452     | -                      | -  | -  | -               | 698,452        |
| Commercial mortgages:        |             |                        |  |  |                 |                |
| Construction                 | 36,988,222  | 294,565                | 4,481,066                                      | 1,182,037  | 434,338         | 43,380,228     |



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|                           |             |             |             |               |              |               |
|---------------------------|-------------|-------------|-------------|---------------|--------------|---------------|
| Other                     | 266,261,798 | 1,750,806   | -           | 8,043,810     | 1,581,643    | 277,638,057   |
| Residential mortgages     | 194,185,616 | 4,145,868   | -           | 244,268       | 2,423,024    | 200,998,776   |
| Consumer loans:           |             |             |             |               |              |               |
| Credit cards              | 1,847,837   | -           | 3,308       | -             | -            | 1,851,145     |
| Home equity lines & loans | 86,486,782  | 211,739     | -           | -             | 571,365      | 87,269,886    |
| Indirect consumer loans   | 129,789,672 | 852,818     | -           | -             | 335,285      | 130,977,775   |
| Direct consumer loans     | 19,481,693  | 89,619      | -           | -             | 19,338       | 19,590,650    |
| Total                     | 867,844,443 | \$7,528,684 | \$4,484,374 | \$ 10,711,533 | \$ 6,031,905 | \$895,900,939 |

(1) Includes all loans on non-accrual status regardless of the number of days such loans were delinquent as of December 31, 2012.

### Troubled Debt Restructurings:

As of June 30, 2013 and December 31, 2012, the Corporation has a recorded investment in troubled debt restructurings of \$7,566,209 and \$5,728,610, respectively. There were specific reserves of \$242,692 allocated for troubled debt restructurings at June 30, 2013 and no specific reserves allocated at December 31, 2012. As of June 30, 2013, troubled debt restructurings totaling \$6,245,177 were accruing interest under the modified terms and \$1,321,032 were on non-accrual status. As of December 31, 2012, troubled debt restructurings totaling \$5,363,712 were accruing interest under the modified terms and \$364,898 were on non-accrual status. The Corporation has committed to lend additional amounts totaling up to \$56,000 and \$130,000 as of June 30, 2013 and December 31, 2012, respectively, to customers with outstanding loans that are classified as troubled debt restructurings.

During the six months ended June 30, 2013 and 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: reduced scheduled payments for greater than 3 months or an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk.

The following table presents loans by class modified as troubled debt restructurings that occurred during the six months ended June 30, 2013 and June 30, 2012:

| Six months ended               | Number of | Pre-Modification    | Post-Modification   |
|--------------------------------|-----------|---------------------|---------------------|
| June 30, 2013                  | Loans     | Outstanding         | Outstanding         |
| Troubled debt restructurings:  |           | Recorded Investment | Recorded Investment |
| Commercial and agricultural:   |           |                     |                     |
| Commercial & industrial        | 4         | \$ 841,162          | \$ 841,162          |
| Commercial mortgages:          |           |                     |                     |
| Other                          | 1         | 133,000             | 133,000             |
| Consumer loans:                |           |                     |                     |
| Home equity lines & loans      | 2         | 103,587             | 103,587             |
| <b>Total</b>                   | <b>7</b>  | <b>\$ 1,077,749</b> | <b>\$ 1,077,749</b> |
| Six months ended June 30, 2012 |           |                     |                     |
| Troubled debt restructurings:  |           |                     |                     |
| Consumer loans:                |           |                     |                     |
| Home equity lines & loans      | 1         | \$ 58,823           | \$ 58,823           |
| <b>Total</b>                   | <b>1</b>  | <b>\$ 58,823</b>    | <b>\$ 58,823</b>    |

The troubled debt restructurings described above increased the allowance for loan losses by \$97,629 and resulted in no charge offs during the six months ended June 30, 2013. The troubled debt restructurings described above did not increase the allowance for loan losses and resulted in no charge offs during the six months ended June 30, 2012.



The following table presents loans by class modified as troubled debt restructurings that occurred during the three months ended June 30, 2013 and June 30, 2012:

| Three months ended<br>June 30, 2013 | Number of<br>Loans | Pre-Modification<br>Outstanding<br>Recorded Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|-------------------------------------|--------------------|--|--|
| Troubled debt restructurings:       |                    |  |  |
| Commercial and agricultural:        |                    |  |  |
| Commercial & industrial             | 2                  | \$ 409,869   | \$ 409,869   |
| Commercial mortgages:               |                    |  |  |
| Other                               | 1                  | 133,000  | 133,000  |
| Total                               | 1                  | \$ 542,869   | \$ 542,869   |

There were no loans modified as troubled debt restructurings during the three months ended June 30, 2012. The troubled debt restructurings described above increased the allowance for loan losses by \$112,040 and resulted in no charge offs during the three months ending June 30, 2013.

There were no payment defaults on any loans previously modified as troubled debt restructurings during the six months ending June 30, 2013 or June 30, 2012, within twelve months following the modification. Additionally there were no payment defaults on any loans previously modified as troubled debt restructurings during the three months ending June 30, 2013, within twelve months following the modification. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

#### Credit Quality Indicators

The Corporation establishes a risk rating at origination for all commercial loans. The main factors considered in assigning risk ratings include, but are not limited to: historic and future debt service coverage, collateral position, operating performance, liquidity, leverage, payment history, management ability, and the customer's industry. Commercial relationship managers monitor all loans in their respective portfolios for any changes in the borrower's ability to service their debt and affirm the risk ratings for the loans at least annually.

For the retail loans, which include lines of credit, installment, mortgage, and home equity loans, once a loan is properly approved and closed, the Corporation evaluates credit quality based upon loan repayment.

The Corporation uses the risk rating system to identify criticized and classified loans. Commercial relationships within the criticized and classified risk ratings are analyzed quarterly. The Corporation uses the following definitions for criticized and classified loans (which are consistent with regulatory guidelines):

**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.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be not rated loans. Based on the analyses performed as of June 30, 2013 and December 31, 2012, the risk category of the recorded investment of loans by class of loans is as follows:

|                              | June 30, 2013 |                |   |                 |               |            |
|------------------------------|---------------|----------------|---|-----------------|---------------|------------|
|                              | Not Rated     | Pass           | Loans acquired with deteriorated credit quality | Special Mention | Substandard   | Doubtful   |
| Commercial and agricultural: |               |                |   |                 |               |            |
| Commercial & industrial      | \$ -          | \$ 120,052,546 | \$ 882,814                                      | \$ 10,577,534   | \$ 2,973,687  | \$ 465,375 |
| Agricultural                 | -             | 713,673        | -   | -               | -             | -          |
| Commercial mortgages:        |               |                |   |                 |               |            |
| Construction                 | -             | 13,124,675     | 1,092,697                                       | 3,809,440       | 1,296,157     | -          |
| Other                        | -             | 292,560,550    | 7,980,935                                       | 13,797,377      | 9,877,996     | -          |
| Residential mortgages        | 195,544,381   | -              | 252,838   | -               | 2,804,184     | -          |
| Consumer loans               |               |                |   |                 |               |            |
| Credit cards                 | 1,680,116     | -              | -   | -               | -             | -          |
| Home equity lines & loans    | 90,067,828    | -              | -   | -               | 658,598       | -          |
| Indirect consumer loans      | 46,716,193    | -              | -   | -               | 280,817       | -          |
| Direct consumer loans        | 19,157,318    | -              | -   | -               | 60,876        | -          |
| Total                        | 453,165,836   | \$ 426,451,444 | \$ 10,209,284                                   | \$ 28,184,351   | \$ 17,952,315 | \$ 465,375 |

|                              | December 31, 2012 |                |   |                 |              |            |
|------------------------------|-------------------|----------------|---|-----------------|--------------|------------|
|                              | Not Rated         | Pass           | Loans acquired with deteriorated credit quality | Special Mention | Substandard  | Doubtful   |
| Commercial and agricultural: |                   |                |   |                 |              |            |
| Commercial & industrial      | \$ -              | \$ 121,145,761 | \$ 1,241,418                                    | \$ 8,008,002    | \$ 2,606,529 | \$ 494,260 |
| Agricultural                 | -                 | 698,452        | -   | -               | -            | -          |
| Commercial mortgages:        |                   |                |   |                 |              |            |
| Construction                 | -                 | 34,882,896     | 1,182,037                                       | 5,153,918       | 2,161,377    | -          |
| Other                        | -                 | 247,793,150    | 8,043,810                                       | 11,974,716      | 9,826,381    | -          |
| Residential mortgages        | 198,336,641       | -              | 244,268   | -               | 2,417,868    | -          |
| Consumer loans               |                   |                |   |                 |              |            |

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|                           |             |               |              |              |              |           |
|---------------------------|-------------|---------------|--------------|--------------|--------------|-----------|
| Credit cards              | 1,851,145   | -             | -            | -            | -            | -         |
| Home equity lines & loans | 86,615,392  | -             | -            | -            | 654,493      | -         |
| Indirect consumer loans   | 30,642,490  | -             | -            | -            | 335,285      | -         |
| Direct consumer loans     | 19,571,312  | -             | -            | -            | 19,338       | -         |
| Total                     | 437,066,980 | \$404,520,259 | \$10,711,533 | \$25,136,636 | \$18,021,271 | \$494,260 |

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, 2013 and December 31, 2012:

|                | June 30, 2013            |              |                              |                               |                                   |
|----------------|--------------------------|--------------|------------------------------|-------------------------------|-----------------------------------|
|                | Consumer Loans           |              |                              |                               |                                   |
|                | Residential<br>Mortgages | Credit Card  | Home Equity<br>Lines & Loans | Indirect<br>Consumer<br>Loans | Other Direct<br>Consumer<br>Loans |
| Performing     | \$ 195,797,219           | \$ 1,664,379 | \$ 90,250,755                | \$ 146,716,193                | \$ 19,157,318                     |
| Non-Performing | 2,804,184                | 15,737       | 475,671                      | 280,817                       | 60,876                            |
| Total          | \$ 198,601,403           | \$ 1,680,116 | \$ 90,726,426                | \$ 146,997,010                | \$ 19,218,194                     |

|                | December 31, 2012        |              |                              |                               |                                   |
|----------------|--------------------------|--------------|------------------------------|-------------------------------|-----------------------------------|
|                | Consumer Loans           |              |                              |                               |                                   |
|                | Residential<br>Mortgages | Credit Card  | Home Equity<br>Lines & Loans | Indirect<br>Consumer<br>Loans | Other Direct<br>Consumer<br>Loans |
| Performing     | \$ 198,575,753           | \$ 1,847,838 | \$ 86,698,520                | \$ 130,642,490                | \$ 19,571,312                     |
| Non-Performing | 2,423,024                | 3,307        | 571,365                      | 335,285                       | 19,338                            |
|                | \$ 200,998,777           | \$ 1,851,145 | \$ 87,269,885                | \$ 130,977,775                | \$ 19,590,650                     |

At the time of the merger with Fort Orange Financial Corp., the Corporation identified certain loans with evidence of deteriorated credit quality, and the probability that the Corporation would be unable to collect all contractually required payments from the borrower. These loans are classified as PCI loans. The Corporation adjusted its estimates of future expected losses, cash flows, and renewal assumptions on the PCI loans during the current year. These adjustments were made for changes in expected cash flows due to loans refinanced beyond original maturity dates, impairments recognized subsequent to the acquisition, advances made for taxes or insurance to protect collateral held and payments received in excess of amounts originally expected.

The table below summarizes the changes in total contractually required principal and interest cash payments, management's estimate of expected total cash payments and carrying value of the PCI loans from January 1, 2013 to June 30, 2013 and April 1, 2013 to June 30, 2013:

|  | Balance at<br>December 31,<br>2012 | Income<br>Accretion | All Other<br>Adjustments | Balance at<br>June 30,<br>2013 |
|--|------------------------------------|---------------------|--------------------------|--------------------------------|
| Six months ended June 30, 2013                               |                                    |                     |                          |                                |
| Contractually required principal and interest                | \$16,896,078                       | \$ -                | \$ (2,195,740)           | \$14,700,338                   |
| Contractual cash flows not expected to be collected          |                                    |                     |                          |                                |
| (nonaccretable discount)                                     | (3,655,500)                        | -                   | 1,716,743                | (1,938,757)                    |
| Cash flows expected to be collected                          | 13,240,578                         | -                   | (478,997)                | 12,761,581                     |
| Interest component of expected cash flows (accretable yield) | (2,529,045)                        | 663,861             | (687,113)                | (2,552,297)                    |
|  | \$10,711,533                       | \$663,861           | \$ (1,166,110)           | \$10,209,284                   |



Fair value of loans acquired with  
deteriorating credit quality

| Three months ended June 30, 2013  | Balance at<br>March 31,<br>2013 | Income<br>Accretion | All Other<br>Adjustments | Balance at<br>June 30,<br>2013 |
|---|---------------------------------|---------------------|--------------------------|--------------------------------|
| Contractually required principal and interest                                   | \$ 15,255,412                   | \$ -                | \$ (555,074)             | \$ 14,700,338                  |
| Contractual cash flows not expected to be collected<br>(nonaccretable discount) | (2,276,866)                     | -                   | 338,109                  | (1,938,757)                    |
| Cash flows expected to be collected   | 12,978,546                      | -                   | (216,965)                | 12,761,581                     |
| Interest component of expected cash flows<br>(accretable yield)                 | (2,376,643)                     | 170,041             | (345,695)                | (2,552,297)                    |
| Fair value of loans acquired with<br>deteriorating credit quality               | \$ 10,601,903                   | \$ 170,041          | \$ (562,660)             | \$ 10,209,284                  |

NOTE 6 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 Corporation used the following methods and significant assumptions to estimate fair value:

Investment Securities: 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 utilizes an external model for pricing these securities. This is the same model used in determining OTTI as further described in Note 4. 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.

Trading Assets: Securities that are held to fund a deferred compensation plan are recorded at fair value with changes in fair value included in earnings. The fair values of trading assets are determined by quoted market prices (Level 1 inputs).

**Impaired Loans:** At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value have been partially charged-off or receive specific allocations as part of the allowance for loan loss accounting. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, typically resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

**Other Real Estate Owned:** Assets acquired through or instead of loan foreclosures are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned ("OREO") are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Corporation. Once received, appraisals are reviewed for reasonableness of assumptions, approaches utilized, Uniform Standards of Professional Appraisal Practice and other regulatory compliance, as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. Appraisals are generally completed within the previous 12-month period prior to a property being placed into OREO. On impaired loans, appraisal values are adjusted based on the age of the appraisal, the position of the lien, the type of the property and its condition.

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

|   | Fair Value     | Fair Value Measurement at June 30, 2013 Using                              |   |  |
|---|----------------|--|---|--|
|   |                | Quoted Prices<br>in Active<br>Markets for<br>Identical 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.<br>Government and U.S.<br>Government sponsored<br>enterprises | \$ 144,450,370 | \$ 31,526,000  | \$ 112,924,370  | \$ -   |
| Mortgage-backed<br>securities, residential  | 22,979,392     | -  | 22,979,392  | -  |
| Obligations of states and<br>political subdivisions                               | 37,003,563     | -  | 37,003,563  | -  |
| Collateralized mortgage<br>obligations  | 2,188,975      | -  | 2,188,975   | -  |
| Corporate bonds and notes   | 7,515,573      | -  | 7,515,573   | -  |

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|                                     |                |               |                |            |
|-------------------------------------|----------------|---------------|----------------|------------|
| SBA loan pools                      | 1,591,911      | -             | 1,591,911      | -          |
| Trust Preferred securities          | 2,515,706      | -             | 2,001,406      | 514,300    |
| Corporate stocks                    | 7,116,462      | 6,473,329     | 643,133        | -          |
| Total available for sale securities | \$ 225,361,952 | \$ 37,999,329 | \$ 186,848,323 | \$ 514,300 |
| Trading assets                      | \$ 388,714     | \$ 388,714    | \$ -           | \$ -       |

| Financial Assets:<br>Obligations of U.S.<br>Government and U.S.<br>Government sponsored<br>enterprises | Fair Value     | Fair Value Measurement at December 31, 2012 Using                             |   |  |
|--|----------------|---|---|--|
|  |                | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Mortgage-backed<br>securities, residential   | \$ 141,591,214 | \$ 37,698,000   | \$ 103,893,214  | \$ -   |
| Obligations of states and<br>political subdivisions  | 31,515,249     | -   | 31,515,249  | -  |
| Collateralized mortgage<br>obligations   | 40,814,722     | -   | 40,814,722  | -  |
| Corporate bonds and notes  | 3,543,360      | -   | 3,543,360   | -  |
| SBA loan pools   | 11,651,635     | -   | 11,651,635  | -  |
| Trust Preferred securities   | 1,724,140      | -   | 1,724,140   | -  |
| Corporate stocks   | 2,470,913      | -   | 2,025,313   | 445,600  |
| Total available for sale<br>securities   | 6,374,530      | 5,720,533   | 653,997   | -  |
|  | \$ 239,685,763 | \$ 43,418,533   | \$ 195,821,630  | \$ 445,600   |
| Trading assets   | \$ 348,241     | \$ 348,241  | \$ -  | \$ -   |

There were no transfers between Level 1 and Level 2 during the six-month period ending June 30, 2013 or the year ending December, 31, 2012.

The significant unobservable inputs used in the fair value measurement of the Corporation's collateralized debt obligations are probabilities of specific-issuer defaults and deferrals and specific-issuer recovery assumptions. Significant increases in specific-issuer default assumptions or decreases in specific-issuer recovery assumptions would result in a significantly lower fair value measurement. Conversely, decreases in specific-issuer default assumptions or increases in specific-issuer recovery assumptions would result in a higher fair value measurement. The Corporation treats all interest payment deferrals as defaults and assumes no recoveries on defaults.

The tables below present a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six-month periods ending June 30, 2013 and 2012:

|   | Fair Value Measurement for<br>Six-Months Ended June 30,<br>2013 Using Significant<br>Unobservable Inputs (Level<br>3) | Fair Value Measurement for<br>Six-Months Ended June 30,<br>2012 Using Significant<br>Unobservable Inputs (Level<br>3) |
|---|---|---|
| Trust Preferred Securities Available for Sale |   |   |
| Beginning balance                             | \$ 445,600  | \$ 294,910  |
| Total gains/losses (realized/unrealized):     |   |   |
| Included in earnings:                         |   |   |

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|  |            |            |
|--|------------|------------|
| Income on securities                       | -          | -          |
| Impairment charge on investment securities | -          | -          |
| Included in other comprehensive income     | 68,700     | 48,125     |
| Transfers in and/or out of Level 3         | -          | -          |
| Ending balance June 30                     | \$ 514,300 | \$ 343,035 |

|   | Fair Value Measurement for<br>Three-Months Ended June 30,<br>2013 Using Significant<br>Unobservable Inputs (Level 3) | Fair Value Measurement for<br>Three-Months Ended June<br>30, 2012 Using Significant<br>Unobservable Inputs (Level<br>3) |
|---|--|---|
| Trust Preferred Securities Available for Sale |  |   |
| Beginning balance                             | \$ 496,825   | \$ 346,210  |
| Total gains/losses (realized/unrealized):     |  |   |
| Included in earnings:                         |  |   |
| Income on securities                          | -  | -   |
| Impairment charge on investment securities    | -  | -   |
| Included in other comprehensive income        | 17,475   | (3,175)   |
| Transfers in and/or out of Level 3            | -  | -   |
| Ending balance March 31                       | \$ 514,300   | \$ 343,035  |

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

|                                    | Fair Value | Fair Value Measurement at June 30, 2013 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 and agricultural:       |            |  |   |  |
| Commercial & industrial            | \$ 257,146 | \$ -   | \$ -  | \$ 257,146   |
| Commercial mortgages:              |            |  |   |  |
| Other                              | 680,723    | -  | -   | 680,723  |
| Consumer loans:                    |            |  |   |  |
| Home equity lines & loans          | 53,856     | -  | -   | 53,856   |
| Total Impaired Loans               | \$ 991,725 | \$ -   | \$ -  | \$ 991,725   |
| Other real estate owned:           |            |  |   |  |
| Commercial and agricultural:       |            |  |   |  |
| Commercial and industrial          | \$ 101,200 | \$ -   | \$ -  | \$ 101,200   |
| Commercial mortgages:              |            |  |   |  |
| Other                              | 257,702    | -  | -   | 257,702  |
| Residential mortgages              | 161,950    | -  | -   | 161,950  |
| Consumer loans:                    |            |  |   |  |
| Home equity lines & loans          | 66,959     | -  | -   | 66,959   |
| Total Other real estate owned, net | \$ 587,811 | \$ -   | \$ -  | \$ 587,811   |





| Financial Assets:<br>Impaired Loans:<br>Commercial and<br>agricultural: | Fair Value | Fair Value Measurement at December 31, 2012 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) |
| Commercial & industrial   | \$ 235,501 | \$ -   | \$ -  | \$ 235,501   |
| Commercial mortgages:   |            | -  | -   |  |
| Other   | 305,222    | -  | -   | 305,222  |
| Total Impaired Loans  | \$ 540,723 | \$ -   | \$ -  | \$ 540,723   |
| Other real estate owned:  |            |  |   |  |
| Commercial and<br>agricultural:   |            |  |   |  |
| Commercial and industrial   | \$ 101,200 | \$ -   | \$ -  | \$ 101,200   |
| Commercial mortgages:   |            |  |   |  |
| Other   | 257,702    | -  | -   | 257,702  |
| Residential mortgages   | 201,679    | -  | -   | 201,679  |
| Consumer loans:   |            |  |   |  |
| Home equity lines & loans   | 4,000      | -  | -   | 4,000  |
| Total Other real estate<br>owned, net                                   | \$ 564,581 | \$ -   | \$ -  | \$ 564,581   |

The following table presents information related to Level 3 non-recurring fair value measurement at June 30, 2013 and December 31, 2012:

| Description             | Fair Value<br>at June 30, 2013     | Technique  | Unobservable Inputs  |
|-------------------------|------------------------------------|--|--|
| Impaired loans          | \$ 991,725                         | Third party real estate and a 100% discount of personal property | 1 Management discount based on underlying collateral characteristics and market conditions |
| Other real estate owned | \$ 587,811                         | Third party appraisals   | 1 Estimated holding period<br>2 Estimated closing costs                                    |
| Description             | Fair Value at December<br>31, 2012 | Technique  | Unobservable Inputs  |
| Impaired loans          | \$ 540,723                         | Third party real estate and a 100% discount of                   | 1 Management discount based on   |

| personal property       |            |                        | underlying collateral characteristics and market conditions |
|-------------------------|------------|------------------------|---|
| Other real estate owned | \$ 564,581 | Third party appraisals | 1<br>Estimated holding period                               |
|                         |            |                        | 2<br>Estimated closing costs                                |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal balance of \$1,761,952 with a valuation allowance of \$770,227 as of June 30, 2013, resulting in \$494,350 and \$577,589 of additional provision for loan losses for the three and six-month periods ended June 30, 2013, respectively. Impaired loans had a principal balance of \$733,361, with a valuation allowance of \$192,638 as of December 31, 2012, resulting in no additional provision for loan losses for the year ending December 31, 2012.

OREO, which is measured by the lower of carrying or fair value less costs to sell, had a net carrying amount of \$587,811 at June 30, 2013. The net carrying amount reflects the outstanding balance of \$780,178 net of a valuation allowance of \$192,367 at June 30, 2013. There were no write downs for the three and six-month periods ending June 30, 2013. OREO had a net carrying amount of \$564,581 at December 31, 2012. The net carrying amount reflects the outstanding balance of \$756,948 net of a valuation allowance of \$192,367 at December 31, 2012, which resulted in write downs of \$116,840 for the year ending December 31, 2012.

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The carrying amounts and estimated fair values of other financial instruments, at June 30, 2013 and December 31, 2012, are as follows (dollars in thousands):

|   | Carrying Amount | Fair Value Measurements at June 30, 2013 Using                 |   |   | Estimated Fair Value (1) |
|---|-----------------|--|---|---|--------------------------|
|   |                 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |                          |
| Financial assets:   |                 |  |   |   |                          |
| Cash and due from financial institutions                  | \$ 23,812       | \$ 23,812  | \$ -  | \$ -                                      | \$ 23,812                |
| Interest-bearing deposits in other financial institutions | 945             | 945  | -   | -   | 945                      |
| Trading assets  | 389             | 389  | -   | -   | 389                      |
| Securities available for sale                             | 225,362         | 37,999   | 186,849                                       | 514                                       | 225,362                  |
| Securities held to maturity                               | 6,570           | -  | 7,064   | -   | 7,064                    |
| Federal Home Loan and Federal Reserve Bank stock          | 4,579           | -  | -   | -   | N/A                      |
| Net loans   | 922,719         | -  | -   | 952,305                                   | 952,305                  |
| Loans held for sale                                       | 947             | -  | 947   | -   | 947                      |
| Accrued interest receivable                               | 3,742           | 143  | 1,234   | 2,365                                     | 3,742                    |
| Financial liabilities:                                    |                 |  |   |   |                          |
| Deposits:   |                 |  |   |   |                          |
| Demand, savings, and insured money market accounts        | 830,003         | 830,003  | -   | -   | 830,003                  |
| Time deposits   | 224,965         | -  | 226,038                                       | -   | 226,038                  |
| Securities sold under agreements to repurchase            | 30,568          | -  | 32,014  | -   | 32,014                   |
| Federal Home Loan Bank advances                           | 26,101          | -  | 27,476  | -   | 27,476                   |
| Accrued interest payable                                  | 405             | 16   | 224   | 165                                       | 405                      |

| Financial Assets: | Carrying Amount | Fair Value Measurements at December 31, 2012  |   |   | Estimated Fair Value (1) |
|-------------------|-----------------|---|---|---|--------------------------|
|                   |                 | Quoted Prices in Active Markets for Identical | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |                          |
|                   |                 |   |   |   |                          |

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|   | Assets<br>(Level 1) |            |         |         |            |
|---|---------------------|------------|---------|---------|------------|
| Cash and due from financial institutions                  | \$ 29,239           | \$ 29,239  | \$ -    | -       | \$ 29,239  |
| Interest-bearing deposits in other financial institutions | 11,002              | 8,645      | 2,357   | -       | 11,002     |
| Trading assets  | 348                 | 348        | -       | -       | 348        |
| Securities available for sale                             | 239,686             | 43,419     | 195,822 | 445     | 239,686    |
| Securities held to maturity                               | 5,748               | -          | 6,421   | -       | 6,421      |
| Federal Home Loan and Federal Reserve Bank stock          | 4,710               | -          | -       | -       | N/A        |
| Net loans   | 883,084             | -          | -       | 916,289 | 916,289    |
| Loans held for sale                                       | 1,057               | -          | 1,057   | -       | 1,057      |
| Accrued interest receivable                               | 3,788               | 175        | 1,257   | 2,356   | 3,788      |
| Financial liabilities:                                    |                     |            |         |         |            |
| Deposits:   |                     |            |         |         |            |
| Demand, savings, and insured money market accounts        | \$ 808,044          | \$ 808,044 | \$ -    | \$ -    | \$ 808,044 |
| Time deposits   | 236,690             | -          | 238,245 | -       | 238,245    |
| Securities sold under agreements to repurchase            | 32,711              | -          | 35,260  | -       | 35,260     |
| Federal Home Loan Bank advances                           | 27,225              | -          | 29,688  | -       | 29,688     |
| Accrued interest payable                                  | 453                 | 12         | 279     | 162     | 453        |

(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:

#### Cash, Due From and Interest-Bearing Deposits in Other Financial Institutions

For those short-term instruments that generally mature in 90 days or less, the carrying value approximates fair value of which non interest-bearing deposits are classified as Level 1 and interest-bearing deposits with the Federal Home Loan Bank of New York ("FHLB") and Federal Reserve Bank of New York ("FRB") are classified as Level 1.

#### FHLB and FRB Stock

It is not practicable to determine the fair value of FHLB and FRB stock due to restrictions placed on its transferability.

#### Loans Receivable

For variable-rate loans that reprice frequently, fair values approximate carrying values. The fair values for other loans are estimated through discounted cash flow analysis using interest rates currently being offered for loans with similar terms and credit quality. Loans are classified as Level 3. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price. Loans held for sale are classified as Level 2.

#### Deposits

The fair values disclosed for demand deposits, savings accounts and money market accounts are, by definition, equal to the amounts payable on demand at the reporting date (i.e., their carrying values) and classified as Level 1.

The fair value of certificates of deposits is estimated using a discounted cash flow approach that applies interest rates currently being offered on certificates to a schedule of the weighted-average expected monthly maturities and classified as Level 2.

#### Securities Sold Under Agreements to Repurchase (Repurchase Agreements)

These instruments bear both variable and fixed rates of interest. Therefore, the carrying value approximates fair value for the variable rate instruments and the fair value of fixed rate instruments is based on discounted cash flows to maturity. These are classified as Level 2.

#### Federal Home Loan Bank Advances

These instruments bear a stated rate of interest to maturity and, therefore, the fair value is based on discounted cash flows to maturity and classified as Level 2.

#### Accrued Interest Receivable and Payable

For these short-term instruments, the carrying value approximates fair value resulting in a classification of Level 1, Level 2 or Level 3 depending upon the classification of the asset/liability they are associated with.

## NOTE 7 GOODWILL AND INTANGIBLE ASSETS

The changes in goodwill included in the core banking segment during the periods ending June 30, 2013 and 2012 were as follows:

|                                     | 2013          | 2012          |
|-------------------------------------|---------------|---------------|
| Beginning of year                   | \$ 21,824,443 | \$ 21,983,617 |
| Acquired goodwill                   | -             |               |
| Adjustment of Acquired goodwill (1) | -             | (159,174)     |
| Ending balance June 30,             | \$ 21,824,443 | \$ 21,824,443 |

(1) Adjustment related to Fort Orange Financial Corp. acquisition.

Acquired intangible assets were as follows at June 30, 2013 and December 31, 2012:

|  | At June 30, 2013    |                             | At December 31, 2012 |                             |
|--|---------------------|-----------------------------|----------------------|-----------------------------|
|  | Balance<br>Acquired | Accumulated<br>Amortization | Balance<br>Acquired  | Accumulated<br>Amortization |
| Core deposit intangibles                   | \$ 3,819,798        | \$ 2,054,776                | \$ 3,819,798         | \$ 1,796,853                |
| Other customer relationship<br>intangibles | 6,063,423           | 3,133,704                   | 6,063,423            | 2,942,548                   |
| Total                                      | \$ 9,883,221        | \$ 5,188,480                | \$ 9,883,221         | \$ 4,739,401                |

Aggregate amortization expense was \$449,079 and \$548,190 for the six-month periods ended June 30, 2013 and 2012, respectively.

The remaining estimated aggregate amortization expense at June 30, 2013 is listed below:

| Year                   | Estimated Expense |
|------------------------|-------------------|
| 2013                   | \$ 427,445        |
| 2014                   | 777,801           |
| 2015                   | 681,176           |
| 2016                   | 607,713           |
| 2017                   | 557,893           |
| 2018 and<br>thereafter | 1,642,713         |
| Total                  | \$ 4,694,741      |

## NOTE 8 ACCUMULATED OTHER COMPREHENSIVE INCOME OR LOSS

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.

The following is a summary of the changes in accumulated other comprehensive income or loss by component, net of tax, for the periods indicated:

|  | Unrealized Gains and<br>Losses on Securities<br>Available for Sale | Defined Benefit<br>and Other Benefit<br>Plans | Total          |
|--|--|---|----------------|
| Balance at December 31, 2012   | \$ 8,022,790   | \$ (10,829,719)                               | \$ (2,806,929) |
| Other comprehensive income before<br>reclassification                  | (2,034,375)  | -   | (2,034,375)    |
| Amounts reclassified from<br>accumulated other<br>comprehensive income | (756)  | 467,013                                       | 466,257        |
| Net current period other<br>comprehensive loss                         | (2,035,131)  | 467,013                                       | (1,568,118)    |
| Balance at June 30, 2013   | \$ 5,987,659   | \$ (10,362,706)                               | \$ (4,375,047) |

|  | Unrealized Gains and<br>Losses on Securities<br>Available for Sale | Defined Benefit<br>and Other Benefit<br>Plans | Total          |
|--|--|---|----------------|
| Balance at March 31, 2013  | \$ 7,979,597   | \$ (10,602,795)                               | \$ (2,623,198) |
| Other comprehensive income before<br>Reclassification                  | (1,991,182)  | -   | (1,991,182)    |
| Amounts reclassified from<br>accumulated other<br>comprehensive income | (756)  | 240,089                                       | 239,333        |
| Net current period other<br>comprehensive loss                         | (1,991,938)  | 240,089                                       | (1,751,849)    |
| Balance at June 30, 2013   | \$ 5,987,659   | \$ (10,362,706)                               | \$ (4,375,047) |

|  | Unrealized Gains and<br>Losses on Securities<br>Available for Sale | Defined Benefit<br>and Other<br>Benefit Plans | Total          |
|--|--|---|----------------|
| Balance at December 31, 2011   | \$ 7,987,055   | \$ (9,428,433)                                | \$ (1,441,378) |
| Other comprehensive income before<br>reclassification                  | 382,446  | -   | 382,446        |
| Amounts reclassified from<br>accumulated other<br>comprehensive income | (184,630)  | 387,536                                       | 202,906        |
| Net current period other<br>comprehensive income                       | 197,816  | 387,536                                       | 585,352        |
| Balance at June 30, 2012   | \$ 8,184,871   | \$ (9,040,897)                                | \$ (856,026)   |

|  | Unrealized Gains and<br>Losses on Securities<br>Available for Sale | Defined Benefit<br>and Other<br>Benefit Plans | Total          |
|--|--|---|----------------|
| Balance at March 31, 2012  | \$ 8,088,581   | \$ (9,234,665)                                | \$ (1,146,084) |
| Other comprehensive income before<br>reclassification                  | 97,983   | -   | 97,983         |
| Amounts reclassified from<br>accumulated other<br>comprehensive income | (1,693)  | 193,768                                       | 192,075        |
| Net current period other<br>comprehensive income                       | 96,290   | 193,768                                       | 290,058        |
| Balance at June 30, 2012   | \$ 8,184,871   | \$ (9,040,897)                                | \$ (856,026)   |



The following is the reclassification out of accumulated other comprehensive income for the periods indicated:

| Details about Accumulated<br>Other<br>Comprehensive Income<br>Components | Six Months Ended June 30, |              | Affected Line Item<br>in the Statement Where<br>Net Income is Presented |
|--|---------------------------|--------------|---|
|  | 2013                      | 2012         |   |
| Unrealized gains and losses on securities<br>available for sale:         |                           |              |   |
| Realized gains on securities available for<br>sale                       | \$ 1,228                  | 299,919      | Net gains on securities<br>transactions                                 |
| Income tax expense   | 472                       | 115,289      | Income tax expense  |
| Net of tax   | 756                       | 184,630      |   |
| Amortization of defined pension plan<br>and other benefit plan items:    |                           |              |   |
| Prior service costs (a)  | 41,572                    | 41,572       | Pension and other<br>employee benefits                                  |
| Actuarial losses (a)   | (801,086)                 | (671,096)    | Pension and other<br>employee benefits                                  |
| Income tax benefit   | 292,501                   | 241,988      | Income tax expense  |
| Net of tax   | (467,013)                 | (387,536)    |   |
| Total reclassification for the period, net of<br>tax                     | \$\$ (466,257)            | \$ (202,906) |   |

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension and other benefit plan costs (see Note 10 for additional information).

| Details about Accumulated<br>Other Comprehensive<br>Income Components | Three Months Ended June 30, |              | Affected Line Item<br>in the Statement Where<br>Net Income is Presented |
|---|-----------------------------|--------------|---|
|   | 2013                        | 2012         |   |
| Unrealized gains and losses on securities<br>available for sale:      |                             |              |   |
| Realized gains on securities available for<br>sale                    | \$ 1,228                    | 2,750        | Net gains on securities<br>transactions                                 |
| Income tax expense  | 472                         | 1,057        | Income tax expense  |
| Net of tax  | 756                         | 1,693        |   |
| Amortization of defined pension plan<br>and other benefit plan items: |                             |              |   |
| Prior service costs (a)   | 20,786                      | 20,786       | Pension and other<br>employee benefits                                  |
| Actuarial losses (a)  | (400,984)                   | (335,548)    | Pension and other<br>employee benefits                                  |
| Income tax benefit  | 140,109                     | 120,994      | Income tax expense  |
| Net of tax  | (240,089)                   | (193,768)    |   |
| Total reclassification for the period, net of<br>tax                  | \$\$ (239,333)              | \$ (192,075) |   |

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension and other benefit plan costs (see Note 10 for additional information).



## NOTE 9 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.

The Bank is a party in two legal proceedings involving its Wealth Management Group Services. In both proceedings, the Bank, as trustee pursuant to written trust instruments, has sought judicial settlement of trust accounts in the New York Surrogate's Court for Chemung County. Individuals who are beneficiaries under the trusts have filed formal objections and/or demand letters with the Court in both of these accounting proceedings, objecting to the final settlement of the trust accounts. The objectants primarily assert that the Bank acted imprudently by failing to diversify the trusts' investments and they claim \$9.6 million and \$24.1 million, consisting of damages and disallowed trustee's commissions, plus unspecified legal fees in the respective proceedings. These proceedings are pending in the Surrogate's Court and are now in the discovery phase. While the outcome of litigation is not predictable the Bank believes that the claims are without merit and is vigorously defending them. As of June 30, 2013, no amount has been accrued for potential losses related to these proceedings as a potential loss is not considered probable or reasonably estimable in the opinion of management.

In the normal course of business, there are various outstanding claims and legal proceedings involving the Corporation or its subsidiaries. Except for the above matter, we believe that we are not a party to any pending legal, arbitration, or regulatory proceedings that could have a material adverse impact on our financial results or liquidity.

## NOTE 10 COMPONENTS OF QUARTERLY AND YEAR TO DATE NET PERIODIC BENEFIT COSTS

|  | Six Months Ended |                  | Three Months Ended |                  |
|--|------------------|------------------|--------------------|------------------|
|  | June 30,<br>2013 | June 30,<br>2012 | June 30,<br>2013   | June 30,<br>2012 |
| <b>Qualified Pension</b>                           |                  |                  |                    |                  |
| Service cost, benefits earned during the period    | \$ 698,808       | \$ 646,702       | \$ 349,404         | \$ 323,351       |
| Interest cost on projected benefit obligation      | 817,242          | 812,220          | 408,621            | 406,110          |
| Expected return on plan assets                     | (1,454,344)      | (1,326,986)      | (727,172)          | (663,493)        |
| Amortization of unrecognized transition obligation | -                | -                | -                  | -                |
| Amortization of unrecognized prior service cost    | 6,928            | 6,928            | 3,464              | 3,464            |
| Amortization of unrecognized net loss              | 781,366          | 661,136          | 390,683            | 330,568          |
| Net periodic pension expense                       | \$ 850,000       | \$ 800,000       | \$ 425,000         | \$ 400,000       |
| <b>Supplemental Pension</b>                        |                  |                  |                    |                  |
| Service cost, benefits earned during the period    | \$ 20,008        | \$ 17,384        | \$ 10,390          | \$ 8,692         |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Interest cost on projected benefit obligation         | 23,950    | 25,546    | 12,436    | 12,773    |
| Expected return on plan assets                        | -         | -         | -         | -         |
| Amortization of unrecognized prior service cost       | -         | -         | -         | -         |
| Amortization of unrecognized net loss                 | 17,150    | 9,960     | 8,906     | 4,980     |
| Net periodic supplemental pension expense             | \$ 61,108 | \$ 52,890 | \$ 31,732 | \$ 26,445 |
| <b>Postretirement, Medical and Life</b>               |           |           |           |           |
| Service cost, benefits earned during the period       | \$ 24,061 | \$ 17,500 | \$ 13,059 | \$ 8,750  |
| Interest cost on projected benefit obligation         | 31,869    | 36,000    | 17,296    | 18,000    |
| Expected return on plan assets                        | -         | -         | -         | -         |
| Amortization of unrecognized prior service cost       | (48,500)  | (48,500)  | (24,250)  | (24,250)  |
| Amortization of unrecognized net gain                 | 2,570     | -         | 1,395     | -         |
| Net periodic postretirement, medical and life expense | \$ 10,000 | \$ 5,000  | \$ 7,500  | \$ 2,500  |

## NOTE 11 SEGMENT REPORTING

The Corporation manages its operations through two primary business segments: core banking and wealth management group 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 wealth management group services segment provides revenues by providing trust and investment advisory services to clients.

Accounting policies for the segments are the same as those described in Note 1. Summarized financial information concerning the Corporation's reportable segments and the reconciliation to the Corporation's consolidated results are 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.

|   | Three Months Ended June 30, 2013 |   |                                    |                        | Six Months Ended June 30, 2013 |   |                                 |                        |
|---|----------------------------------|---|------------------------------------|------------------------|--------------------------------|---|---------------------------------|------------------------|
|   | Core<br>Banking                  | Wealth<br>Management<br>Group<br>Services | Holding<br>Company<br>And<br>Other | Consolidated<br>Totals | Core Banking                   | Wealth<br>Management<br>Group<br>Services | Holding<br>Company<br>And Other | Consolidated<br>Totals |
| Net interest income                                 | \$ 11,323,855                    | \$ -                                      | \$ 3,917                           | \$ 11,327,772          | \$ 23,039,183                  | \$ -                                      | \$ 5,556                        | \$ 23,044,739          |
| Provision for loan losses                           | 450,474                          | -   | -                                  | 450,474                | 881,484                        | -   | -                               | 881,484                |
| Net interest income after provision for loan losses | 10,873,381                       | -   | 3,917                              | 10,877,298             | 22,157,699                     | -   | 5,556                           | 22,163,255             |
| Other operating income                              | 2,318,089                        | 1,884,949                                 | 272,100                            | 4,475,138              | 4,312,660                      | 3,635,127                                 | 548,928                         | 8,496,715              |
| Other operating expenses                            | 9,924,092                        | 1,276,345                                 | 191,067                            | 11,391,504             | 19,862,144                     | 2,802,901                                 | 451,216                         | 23,116,261             |
| Income before income tax expense                    | 3,267,378                        | 608,604                                   | 84,950                             | 3,960,932              | 6,608,215                      | 832,226                                   | 103,268                         | 7,543,709              |
| Income tax expense                                  | 1,057,703                        | 233,947                                   | 14,675                             | 1,306,325              | 2,135,217                      | 319,908                                   | 22,209                          | 2,477,334              |
| Segment net   | \$ 2,209,675                     | \$ 374,657                                | \$ 70,275                          | \$ 2,654,607           | \$ 4,472,998                   | \$ 512,318                                | \$ 81,059                       | \$ 5,066,374           |

income

Segment

assets

\$1,249,985,668 \$5,044,818 \$2,130,001 \$1,257,160,4

|   | Three Months Ended June 30, 2012 |   |                                    |                        | Six Months Ended June 30, 2012 |   |                                 |                        |
|---|----------------------------------|---|------------------------------------|------------------------|--------------------------------|---|---------------------------------|------------------------|
|   | Core<br>Banking                  | Wealth<br>Management<br>Group<br>Services | Holding<br>Company<br>And<br>Other | Consolidated<br>Totals | Core Banking                   | Wealth<br>Management<br>Group<br>Services | Holding<br>Company<br>And Other | Consolidated<br>Totals |
| Net interest income                                 | \$11,378,763                     | \$ -                                      | \$ 1,418                           | \$ 11,380,181          | \$ 23,406,293                  | \$ -                                      | \$ 5,094                        | \$ 23,411,387          |
| Provision for loan losses                           | 51,593                           | -   | -                                  | 51,593                 | 528,897                        | -   | -                               | 528,897                |
| Net interest income after provision for loan losses | 11,327,170                       | -   | 1,418                              | 11,328,588             | 22,877,396                     | -   | 5,094                           | 22,882,490             |
| Other operating income                              | 2,121,404                        | 1,726,812                                 | 263,939                            | 4,112,155              | 5,191,434                      | 3,502,388                                 | 308,730                         | 8,692,552              |
| Other operating expenses                            | 10,255,351                       | 1,407,501                                 | 218,569                            | 11,881,421             | 19,568,445                     | 2,842,537                                 | 401,659                         | 22,412,641             |
| Income or (loss) before income tax expense          | 3,193,223                        | 319,311                                   | 46,788                             | 3,559,322              | 8,500,385                      | 659,851                                   | (87,835)                        | 9,172,401              |
| Income tax expense (benefit)                        | 991,882                          | 122,743                                   | 657                                | 1,115,282              | 2,829,753                      | 253,647                                   | (69,572)                        | 3,053,828              |
| Segment net income (loss)                           | \$ 2,201,341                     | \$ 196,568                                | \$ 46,131                          | \$ 2,444,040           | \$ 5,670,632                   | \$ 406,204                                | \$ (18,263)                     | \$ 6,118,572           |
| Segment assets                                      |                                  |   |                                    |                        | \$1,259,535,663                | \$5,355,782                               | \$2,567,652                     | \$1,267,459,107        |

## NOTE 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 Chief Executive Officer 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 12 months during the prior year.

During January 2013 and 2012, 7,969 and 10,238 shares, respectively, were re-issued from treasury to fund the stock component of directors' compensation. An expense of \$134,475 and \$106,525 related to this compensation was recognized during the period ending June 30, 2013 and June 30, 2012, respectively. This expense is accrued as shares are earned.

## Restricted Stock Plan

Pursuant to the Corporation's Restricted Stock Plan (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.

A summary of restricted stock activity from December 31, 2012 to June 30, 2013 is presented below:

|                                | Shares | Weighted-Average<br>Grant Date Fair<br>Value |
|--------------------------------|--------|--|
| Nonvested at December 31, 2012 | 20,009 | \$ 23.84                                     |
| Granted                        | -      | -  |
| Vested                         | 1,794  | 22.33  |
| Forfeited or Cancelled         | -      | -  |
| Nonvested at June 30, 2013     | 18,215 | \$ 23.98                                     |

As of June 30, 2013, there was \$379,102 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 3.89 years. The total fair value of shares vested during the six months ended June 30, 2013 was \$53,838.

## NOTE 13 SUBSEQUENT EVENT

On July 10, 2013, the Bank, the wholly-owned banking subsidiary of the Corporation entered into a Purchase and Assumption Agreement with Bank of America, National Association ("BOA") pursuant to which the Bank agreed to acquire certain assets and assume certain liabilities of six BOA branch offices located in Auburn, Cortland, Ithaca and Seneca Falls, New York. Subject to the terms of the Purchase Agreement, the Bank will acquire approximately \$261,000,000 in deposits and \$1,600,000 in loans, for a purchase price equal to the sum of a deposit premium of 1.5% based on the 30-day average balances prior to the close of the transaction, the aggregate net book value of all assets and accrued interest on the loans acquired. The Bank will not receive any loans that are past due 30 days or more on the closing date. The transaction, which is subject to regulatory approval, is expected to close in the fourth quarter of

2013.

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

The purpose of this review is to focus on information about the financial condition and results of operations of Chemung Financial Corporation (the "Corporation") for the three and six-month periods ended June 30, 2013 and 2012. The following discussion and unaudited consolidated interim financial statements and related notes included in this report should be read in conjunction with our 2012 Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 15, 2013. 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.

To assist the reader, the Corporation has provided the following list of commonly used acronyms and abbreviations included in Management's Discussion and Analysis of Financial Condition and Results of Operations.

|   |   |
|---|---|
| CDO: Collateralized Debt Obligation                 | OTTI: Other-than-temporary Impairment   |
| FASB: Financial Accounting Standards Board          | PCI: Purchased Credit Impaired          |
| FDIC: Federal Deposit Insurance Corporation         | SEC: Securities and Exchange Commission |
| FHLB: Federal Home Loan Bank                        | TDR: Troubled Debt Restructurings       |
| GAAP: U.S. generally accepted accounting principles |   |

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 that its forward-looking statements to be covered by the safe harbor provisions for forward-looking statements in these sections. All statements regarding, among other things, the Corporation's expected financial condition and results of operations, 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," "believe" 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, including our local, state and national real estate markets and employment trends, or changes in interest rates, credit risk, difficulties in managing the Corporation's growth, competition, changes in law or the regulatory environment, including the Dodd-Frank Wall Street Reform, the Jumpstart Our Business Startups Act and Consumer Protection Act, the capital ratios of Basel III, as adopted by the federal banking authorities, political instability and changes in general business and economic trends or demand for loans. Information concerning these and other factors can be found in the Corporation's periodic filings with the SEC, including in our 2012 Annual Report on Form 10-K. These filings are available publicly on the SEC's web site at <http://www.sec.gov>, on the Corporation's web site at <http://www.chemungcanal.com> or upon request from the Corporate Secretary at (607) 737-3746. 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 GAAP. 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 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 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. 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 pool, as well as overall default rates based on historical bank debt default rate averages.

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

### Summary

Assets totaled \$1.257 billion at June 30, 2013 compared with \$1.248 at December 31, 2012, an increase of \$9.0 million, or 0.7%. The growth was due primarily to an increase of \$40.5 million, or 4.5%, in total portfolio loans, partially offset by decreases of \$15.5 million in cash and cash equivalents and \$13.6 million in investment securities. The increase in portfolio loans was due to strong growth of \$24.0 million in commercial loans and \$19.0 million in consumer loans.

Total liabilities were \$1.124 billion at June 30, 2013 compared with \$1.117 billion at December 31, 2012, an increase of \$7.4 million, or 0.7%. The increase was due primarily to an increase of \$10.2 million in deposits, partially offset by a decrease of \$3.3 million in borrowings.

Total equity was \$132.7 million at June 30, 2013 compared with \$131.1 million at December 31, 2012. The increase was due primarily to net income of \$5.1 million for the six months ended June 30, 2013, partially offset by dividends declared of \$2.4 million and an increase of \$1.6 million in accumulated other comprehensive loss. The total equity to total assets ratio was 10.55% at June 30, 2013 compared with 10.50% at December 31, 2012. The tangible equity to tangible assets ratio was 8.63% at June 30, 2013 compared with 8.53% at December 31, 2012.

The market value of total assets under management or administration in the Corporation's Wealth Management Group was \$1.782 billion at June 30, 2013 compared with \$1.735 billion at December 31, 2012.

### Cash and Cash Equivalents

Total cash and cash equivalents decreased \$15.5 million since December 31, 2012, primarily due to decreases of \$10.1 million in interest-bearing deposits in other financial institutions and \$5.4 million in cash and due from financial institutions. The decrease in cash and cash equivalents was used to help fund the increase in portfolio loans.

### Securities

The Corporation's Funds Management Policy includes an investment policy that in general, requires debt securities purchased for the bond portfolio to carry a minimum agency rating of "A". After a credit analysis is performed, the policy also allows the Corporation to purchase local municipal obligations that are not rated. The Corporation intends to maintain a reasonable level of securities to provide adequate liquidity and in order to have securities available to pledge to secure public deposits, repurchase agreements and other types of transactions. Fluctuations in the fair value of the Corporation's securities relate primarily to changes in interest rates.

Marketable securities are classified as Available for Sale, while investments in local municipal obligations are generally classified as Held to Maturity. The composition of the available for sale segment of the securities portfolio is summarized as follows (in thousands of dollars):

| Securities Available for Sale   | June 30, 2013  |                      |                           | December 31, 2012 |                      |                           |
|---|----------------|----------------------|---------------------------|-------------------|----------------------|---------------------------|
|   | Amortized Cost | Estimated Fair Value | Unrealized Gains (Losses) | Amortized Cost    | Estimated Fair Value | Unrealized Gains (Losses) |
| Obligations of U.S. Government and U.S Government sponsored enterprises | \$ 143,415     | \$ 144,450           | \$ 1,035                  | \$ 138,041        | \$ 141,591           | \$ 3,550                  |
| Mortgage-backed securities, residential                                 | 21,870         | 22,979               | 1,109                     | 29,592            | 31,515               | 1,923                     |
| Collateralized mortgage obligations                                     | 2,166          | 2,189                | 23                        | 3,495             | 3,543                | 48                        |
| Obligations of states and political subdivisions                        | 36,005         | 37,004               | 999                       | 39,175            | 40,815               | 1,640                     |
| Corporate bonds and notes   | 7,401          | 7,516                | 115                       | 11,412            | 11,652               | 240                       |
| SBA loan pools  | 1,555          | 1,592                | 37                        | 1,683             | 1,724                | 41                        |
| Trust preferred securities  | 2,523          | 2,516                | (7)                       | 2,519             | 2,471                | (48)                      |
| Corporate stocks  | 700            | 7,116                | 6,416                     | 736               | 6,375                | 5,639                     |
| Totals  | \$ 215,635     | \$ 225,362           | \$ 9,727                  | \$ 226,653        | \$ 239,686           | \$ 13,033                 |

The available for sale segment of the securities portfolio totaled \$225.4 million at June 30, 2013, a decrease of \$14.3 million, or 6.0%, from \$239.7 million at December 31, 2012. The decrease resulted primarily from sales and calls of \$10.5 million, maturities and principal collected of \$31.1 million and a decrease of \$3.3 million in unrealized gains. These items were partially offset by purchases of \$31.8 million. The decrease in securities available for sale was used to help fund the increase in portfolio loans.

The held to maturity segment of the securities portfolio consists of obligations of political subdivisions in the Corporation's market areas. These securities totaled \$6.6 million at June 30, 2013, a net increase of \$0.8 million due primarily to the purchase of securities, from December 31, 2012.

#### Loans

The composition of the loan portfolio, net of deferred origination fees and costs, and unearned income is summarized as follows (in thousands of dollars):

|                             | June 30, 2013 | December 31, 2012 |
|-----------------------------|---------------|-------------------|
| Commercial and agricultural | \$ 135,329    | \$ 133,851        |
| Commercial mortgages        | 342,688       | 320,198           |
| Residential mortgages       | 198,072       | 200,475           |
| Consumer loans              | 257,951       | 238,993           |
| Total loans, net            | \$ 934,040    | \$ 893,517        |

Portfolio loans totaled \$934.0 million at June 30, 2013, an increase of \$40.5 million, or 4.5%, from \$893.5 million at December 31, 2012. The increase in portfolio loans was due to strong growth of \$24 million, or 5.3%, in commercial loans and \$19.0 million in consumer loans. The growth in commercial loans was due primarily to an increase in commercial mortgages in the Albany, New York region, of the Corporation's Capital Bank division. The growth in consumer loans was primarily in indirect consumer loans as the Corporation extended into 2013 its loan program with reduced pricing on high quality indirect auto loans.

Residential mortgage loans totaled \$198.1 million at June 30, 2013, a decrease of \$2.4 million, or 1.2%, from December 31, 2012. In addition, during the six months ended June 30, 2013, \$9.5 million of newly originated residential mortgages were sold in the secondary market to Federal Home Loan Mortgage Corporation, with no additional mortgages sold to the State of New York Mortgage Agency. During the twelve months ended December 31, 2012, \$15.8 million of residential mortgages were sold in the secondary market.

The Corporation anticipates that future growth in portfolio loans will continue to be in commercial mortgages and indirect consumer loans.

## Non-Performing Assets

Non-performing assets consist of non-accrual loans, non-accrual troubled debt restructurings and other real estate owned that has been acquired in partial or full satisfaction of loan obligations or upon foreclosure.

Past due status on all loans is based on the contractual terms of the loan. 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. At the time loans are placed in non-accrual status, the accrual of interest is discontinued and previously accrued interest is reversed. All payments received on non-accrual loans are applied to principal. Loans can be returned to accrual status when they become current as to principal and interest and remain current for a period of six consecutive months or when, in the opinion of management, the Corporation expects to receive all of its original principal and interest. 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.

The following table summarizes the Corporation's non-performing assets, excluding acquired PCI loans (in thousands of dollars):

|  | June 30, 2013 | December 31, 2012 |
|--|---------------|-------------------|
| Non-accrual loans  | \$ 6,147      | \$ 5,667          |
| Non-accrual troubled debt restructurings                   | 1,321         | 365               |
| Total non-performing loans                                 | \$ 7,468      | \$ 6,032          |
| Other real estate owned                                    | 588           | 565               |
| Total non-performing assets                                | \$ 8,056      | \$ 6,597          |
| Ratio of non-performing loans to total loans               | 0.80%         | 0.68%             |
| Ratio of non-performing assets to total assets             | 0.64%         | 0.53%             |
| Ratio of allowance for loan losses to non-performing loans | 151.58%       | 172.96%           |
| Accruing loans past due 90 days or more                    | \$ 2,200      | \$ 4,484          |
| Accruing troubled debt restructurings                      | \$ 6,245      | \$ 5,364          |

## Non-Performing Loans

The recorded investment in non-performing loans at June 30, 2013 totaled \$7.5 million compared to \$6.0 million at December 31, 2012, an increase of \$1.5 million. The increase in non-performing loans was due primarily to an increase of \$0.9 million in non-accrual commercial mortgages and slight increases in the commercial and agricultural and residential mortgage segments of the loan portfolio.

The recorded investment in accruing loans past due 90 days or more totaled \$2.2 million at June 30, 2013 compared with \$4.5 million at December 31, 2012. The decrease was due primarily to a \$2.3 million reduction in acquired construction loans not considered by management to be PCI loans, which for a variety of reasons are 90 days or more past their stated maturity dates. These loans totaled \$2.2 million at June 30, 2013. 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.



Not included in non-performing loans at June 30, 2013 are \$10.2 million of acquired loans which the Corporation has identified as PCI loans. The PCI loans are accounted for under separate accounting guidance, Accounting Standards Codification (“ASC”) Subtopic 310-30, “Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality” as disclosed in “Note 5 Loans and Allowance for Loan Losses” to the unaudited interim financial statements.

### Troubled Debt Restructurings

The Corporation works closely with borrowers that have financial difficulties to identify viable solutions that minimize the potential for loss. In that regard, the Corporation modified the terms of select loans to maximize their collectability. The modified loans are considered TDRs under current accounting guidance. Modifications generally involve short-term deferrals of principal and/or interest payments, reductions of scheduled payment amounts, interest rates or principal of the loan, and forgiveness of accrued interest. As of June 30, 2013, the Corporation had \$1.3 million of non-accrual TDRs compared with \$0.4 million as of December 31, 2012. As of June 30, 2013, the Corporation had \$6.2 million of accruing TDRs compared with \$5.4 million as of December 31, 2012. The increase in total TDRs was due primarily to restructuring the loans of four commercial borrowers that recently experienced financial difficulties.

### Impaired Loans

Impaired loans at June 30, 2013 totaled \$12.4 million, including performing TDRs of \$6.2 million, compared to \$12.7 million, including performing TDRs of \$5.4 million, at December 31, 2012. The decrease of \$0.3 million was primarily in commercial mortgages. Included in the impaired loan total at June 30, 2013 are loans totaling \$1.8 million for which impairment allowances of \$0.8 million have been specifically allocated to the allowance for loan losses. Included in the impaired loan total at December 31, 2012, are loans totaling \$0.8 million for which impairment allowances of \$0.2 million have been specifically allocated to the allowance for loan losses. Not included in the impaired loan totals are acquired loans identified as PCI loans.

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, by independent third parties, 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. 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. 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. 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. Non-real estate collateral may be valued using (i) an appraisal, (ii) net book value of the collateral per the borrower's financial statements, or (iii) aging reports, that may be adjusted based on management's knowledge of the client and client's business. If market conditions warrant, future appraisals are obtained for both real estate and non-real estate collateral.

### Allowance for Loan Losses

The allowance is an amount that management believes will be adequate to absorb probable incurred losses on existing loans. The allowance for loan losses is increased through a provision for loan losses charged to operations. 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. 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 (general component) and review of specific impaired loans (including evaluations of the underlying collateral and expected cash flows). 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. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is determined to be impaired and is placed on nonaccrual status, all future payments received are applied to principal.

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. Troubled debt restructurings are impaired loans.

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: (1) lending policies and procedures, including underwriting standards and collection, charge-off and recovery policies, (2) national and local economic and business conditions and developments, including the condition of various market segments, (3) loan profiles and volume of the portfolio, (4) the experience, ability, and depth of lending management and staff, (5) the volume and severity of past due, classified and watch-list loans, non-accrual loans and troubled debt restructurings, (6) the quality of the Bank's loan review system and the degree of oversight by the Bank's Board of Directors, (7) collateral related issues: secured vs. unsecured, type, declining valuation environment and trend of other related factors, (8) the existence and effect of any concentrations of credit, and changes in the level of such concentrations, (9) the effect of external factors, such as competition and legal and regulatory requirements, on the level of estimated credit losses in the Bank's current portfolio and (10) impact of the global economy.

The allowance for loan losses was \$11.3 million at June 30, 2013, up from \$10.4 million at December 31, 2012. The ratio of allowance for loan losses to total loans was 1.21% at June 30, 2013, up from 1.17% at December 31, 2012. The increase in the allowance for loan losses was due primarily to loan portfolio growth and allowances for this growth after consideration of the factors discussed above.

The following table summarizes the activity in the allowance for loan losses for the six months ended June 30, 2013 and 2012 (in thousands of dollars, except ratio data):

|  | Six Months Ended |               |
|--|------------------|---------------|
|  | June 30, 2013    | June 30, 2012 |
| Balance at beginning of period                                     | \$ 10,433        | \$ 9,659      |
| Reclassification of acquired loan discount                         | -                | 124           |
| Charge-offs:   |                  |               |
| Commercial and agricultural  | 18               | 6             |
| Commercial mortgages   | -                | 57            |
| Residential mortgages  | 54               | 73            |
| Consumer loans   | 398              | 273           |
| Total charge-offs  | 470              | 409           |
| Recoveries:  |                  |               |
| Commercial and agricultural  | 294              | 352           |
| Commercial mortgages   | 19               | 30            |
| Residential mortgages  | 39               | -             |
| Consumer loans   | 124              | 108           |
| Total recoveries   | 476              | 490           |
| Net charge-offs (recoveries)                                       | (6)              | (81)          |
| Provision charged to operations                                    | 881              | 529           |
| Balance at end of period   | \$ 11,320        | \$ 10,393     |
| Ratio of net charge-offs (recoveries) to average loans outstanding | - %              | (0.01)%       |
| Ratio of allowance for loan losses to total loans outstanding      | 1.21 %           | 1.21%         |

#### Deposits

A summary of deposits at June 30, 2013 and December 31, 2012 is as follows (in thousands of dollars):

|                                      | June 30, 2013 | December 31, 2012 | Dollar Change | Percent Change |
|--------------------------------------|---------------|-------------------|---------------|----------------|
| Non-interest-bearing demand deposits | \$ 297,523    | \$ 300,610        | \$ (3,087)    | (1.03)%        |
| Interest-bearing demand deposits     | 89,027        | 90,730            | (1,703)       | (1.88)%        |
| Insured money market accounts        | 261,060       | 243,115           | 17,945        | 7.38 %         |
| Savings deposits                     | 182,393       | 173,589           | 8,804         | 5.07 %         |
| Time deposits                        | 224,965       | 236,690           | (11,725)      | (4.95)%        |
| Total                                | \$ 1,054,968  | \$ 1,044,734      | \$ 10,234     | 0.98 %         |

The growth in deposits is a result of the Corporation's deposit strategy, which is to fund the Bank with stable, low-cost deposits, primarily checking account deposits and other low interest-bearing deposit accounts. A checking account is the driver of a banking relationship and consumers consider the bank where they have their checking account as their

primary bank. These customers will typically turn to their primary bank first when in need of other financial services. Strategies that have been developed and implemented to generate these deposits include: (i) acquire deposits by entering new markets through de novo branching, (ii) an annual checking account marketing campaign, (iii) training branch employees to identify and meet client financial needs with Bank products and services, (iv) link business and consumer loans to primary checking account at the Bank, (v) aggressively promote direct deposit of client's payroll checks or benefit checks and (vi) constantly monitor the Corporation's pricing strategies to ensure competitive products and services.

Sorted by public, commercial and consumer sources, the \$10.2 million growth in deposits was due to increases of \$5.4 million in consumer accounts, \$3.3 million in public funds and \$1.5 million in commercial accounts. The growth in consumer deposits was due primarily to increases in non-interest-bearing demand deposits, money market accounts and savings deposits. These items were partially offset by decreases in time deposits and interest-bearing demand deposits. The growth in public funds was due primarily to increases in savings deposits and interest-bearing demand deposits, partially offset by a decrease in non-interest-bearing demand deposits. The Corporation had anticipated a decline in time deposits since its strategy was to focus on core checking accounts.

The Corporation also considers brokered deposits to be an element of its deposit strategy and anticipates that it will continue using brokered deposits as a secondary source of funding to support growth. The Corporation's use of brokered deposits as part of its funding strategy complies with the FDIC's guidance and regulations on the use of brokered deposits by insured banks. Brokered deposits include funds obtained through brokers, and the Bank's participation in the Certificate of Deposit Account Registry Service ("CDARS") program. The CDARS program involves a network of financial institutions that exchange funds among members in order to ensure FDIC insurance coverage on customer deposits above the single institution limit. Using a sophisticated matching system, funds are exchanged on a dollar-for-dollar basis, so that the equivalent of an original deposit comes back to the originating institution. Deposits obtained through brokers were \$7.8 million as of June 30, 2013 compared with \$8.8 million as of December 31, 2012. Deposits obtained through the CDARS program were \$9.3 million as of June 30, 2013 compared with \$8.1 million as of December 31, 2012. The Corporation plans to offer the CDARS program to local municipalities in 2013.

#### Borrowings

Both the repayment of FHLB term advances and decline in securities sold under agreement to repurchase reflect the decrease of \$3.3 million in borrowings during the six months ended June 30, 2013. As a result of the increase in deposits during the six months ended June 30, 2013, the Corporation decided not to increase borrowings to help fund loan growth.

#### Shareholders' Equity

Total shareholders' equity was \$132.7 million at June 30, 2013 compared with \$131.1 million at December 31, 2012. The increase was due primarily to \$5.1 million in net income for 2013, partially offset by dividends declared of \$2.4 million and an increase of \$1.6 million in accumulated other comprehensive loss. The total shareholders' equity to total assets ratio was 10.55% at June 30, 2013 compared with 10.50% at December 31, 2012. The tangible equity to tangible assets ratio was 8.63% at June 30, 2013 compared with 8.53% at December 31, 2012.

The Corporation and the Bank are subject to capital adequacy guidelines of the Federal Reserve and establish a framework for the classification of financial holding companies and financial institutions into five categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. As of June 30, 2013, both the Corporation's and the Bank's capital ratios were in excess of those required to be considered well-capitalized under regulatory capital guidelines.

## Results of Operations

### Comparison of Six Months Ended June 30, 2013 and 2012

#### Net Income

Net income for the six months ended June 30, 2013 was \$5.1 million, a decrease of \$1.0 million, or 16.4%, compared with \$6.1 million for the six months ended June 30, 2012. Earnings per share for the six months ended June 30, 2013 was \$1.09, compared with \$1.31 for the six months ended June 30, 2012. Return on average assets and return on average equity for six months ended June 30, 2013 were 0.81% and 7.65%, respectively, compared with 0.98% and 9.43%, respectively, for the same period in the prior year.

The decline in 2013 earnings was due primarily to a decrease of \$0.4 million in net interest income and reductions of \$0.3 million in net gain on securities transactions and \$0.8 million in pre-tax casualty gains from insurance reimbursements. In addition, the provision for loan losses increased \$0.4 million and non-interest expense increased \$0.3 million. These items were partially offset by an increase of \$0.6 million in the remaining non-interest income categories and a reduction of \$0.5 million in income taxes.

#### Net Interest Income

Net interest income, which is the difference between income received on interest-earning assets, such as loans and securities, and interest paid on interest-bearing liabilities, such as deposits and borrowings, is the largest contributor to earnings.

Net interest income for the six months ended June 30, 2013 totaled \$23.0 million, a decrease of \$0.4 million, or 1.6%, compared with \$23.4 million for the same period in the prior year. Net interest margin was 3.97% for the six months ended June 30, 2013 compared with 4.13% for the same period in the prior year. The decline in net interest income was primarily due to a 32 basis point decrease in yield on interest-earning assets, partially offset by an increase of \$31.2 million in average earning assets. The decline in net interest margin was due primarily to yields on interest-earning assets decreasing as a faster rate than the cost of interest-bearing liabilities. The decrease in yield on interest-earning assets was attributable to a 74 basis point decrease in yield on loans, a result of loans continuing to reprice at current historically low market rates.



## Average Consolidated Balance Sheet and Interest Analysis

The following table sets forth certain information related to the Corporation's average consolidated balance sheets and its consolidated statements of income for the periods indicated and reflects the average yield on assets and average cost of liabilities for the periods indicated. For the purpose of the table below, non-accruing loans are included in the daily average loan amounts outstanding. Daily balances were used for average balance computations. Investment securities are stated at amortized cost. No tax equivalent adjustments have been made in calculating yields on obligations of states and political subdivisions.

| (in thousands of dollars)                      | Six Months Ended June 30, 2013 |               |              | Six Months Ended June 30, 2012 |               |              | Three Months Ended June 30, 2013 |               |              | Three Months Ended June 30, 2012 |
|--|--------------------------------|---------------|--------------|--------------------------------|---------------|--------------|----------------------------------|---------------|--------------|----------------------------------|
|  | Average Balance                | Interest      | Yield/Rate   | Average Balance                | Interest      | Yield/Rate   | Average Balance                  | Interest      | Yield/Rate   |                                  |
| <b>Assets</b>                                  |                                |               |              |                                |               |              |                                  |               |              |                                  |
| <b>Earning assets:</b>                         |                                |               |              |                                |               |              |                                  |               |              |                                  |
| Loans  | \$ 919,358                     | \$ 22,361     | 4.90%        | \$ 809,894                     | \$ 22,705     | 5.64%        | \$ 929,439                       | \$ 11,056     | 4.77%        | \$ 823,110                       |
| Taxable securities                             | 191,836                        | 2,117         | 2.23%        | 228,926                        | 2,863         | 2.52%        | 185,728                          | 986           | 2.13%        | 222,110                          |
| Tax-exempt securities                          | 44,947                         | 586           | 2.63%        | 51,306                         | 676           | 2.65%        | 43,205                           | 281           | 2.61%        | 50,110                           |
| Interest-bearing deposits                      | 14,105                         | 18            | 0.25%        | 48,934                         | 61            | 0.25%        | 15,490                           | 10            | 0.25%        | 53,110                           |
| <b>Total earning assets</b>                    | <b>1,170,246</b>               | <b>25,082</b> | <b>4.32%</b> | <b>1,139,060</b>               | <b>26,305</b> | <b>4.64%</b> | <b>1,173,862</b>                 | <b>12,333</b> | <b>4.21%</b> | <b>1,150,440</b>                 |
| <b>Non-earning assets:</b>                     |                                |               |              |                                |               |              |                                  |               |              |                                  |
| Cash and due from banks                        | 23,178                         |               |              | 23,533                         |               |              | 22,042                           |               |              | 23,110                           |
| Premises and equipment, net                    | 25,213                         |               |              | 24,851                         |               |              | 24,934                           |               |              | 24,110                           |
| Other assets                                   | 47,151                         |               |              | 52,998                         |               |              | 46,803                           |               |              | 51,110                           |
| Allowance for loan losses                      | (10,734)                       |               |              | (10,124)                       |               |              | (10,906)                         |               |              | (10,110)                         |
| AFS valuation allowance                        | 12,880                         |               |              | 13,639                         |               |              | 12,737                           |               |              | 13,110                           |
| <b>Total</b>                                   | <b>\$ 1,267,934</b>            |               |              | <b>\$ 1,243,957</b>            |               |              | <b>\$ 1,269,472</b>              |               |              | <b>\$ 1,252,440</b>              |
| <b>Liabilities and Shareholders' Equity</b>    |                                |               |              |                                |               |              |                                  |               |              |                                  |
| <b>Interest-bearing liabilities:</b>           |                                |               |              |                                |               |              |                                  |               |              |                                  |
| <b>Interest-bearing demand deposits</b>        |                                |               |              |                                |               |              |                                  |               |              |                                  |
| deposits                                       | \$ 98,452                      | \$ 49         | 0.10%        | \$ 85,630                      | \$ 45         | 0.11%        | \$ 93,210                        | \$ 23         | 0.10%        | \$ 90,110                        |
| <b>Savings and insured money</b>               |                                |               |              |                                |               |              |                                  |               |              |                                  |
| market deposits                                | 441,152                        | 407           | 0.19%        | 405,903                        | 416           | 0.21%        | 449,434                          | 208           | 0.19%        | 410,110                          |
| Time deposits                                  | 230,930                        | 763           | 0.67%        | 265,959                        | 1,266         | 0.96%        | 228,324                          | 364           | 0.64%        | 262,110                          |
| FHLB, other advances and securities sold under | 59,047                         | 818           | 2.79%        | 78,446                         | 1,167         | 2.99%        | 58,892                           | 410           | 2.80%        | 76,110                           |

agreements  
to repurchase

|                                    |              |           |       |              |       |           |              |       |           |              |
|------------------------------------|--------------|-----------|-------|--------------|-------|-----------|--------------|-------|-----------|--------------|
| Total interest-bearing liabilities | 829,581      | 2,037     | 0.49% | 835,938      | 2,894 | 0.70%     | 829,860      | 1,005 | 0.49%     | 839,865      |
| Non-interest-bearing liabilities:  |              |           |       |              |       |           |              |       |           |              |
| Demand deposits                    | 294,302      |           |       | 270,314      |       |           | 294,680      |       |           | 274,314      |
| Other liabilities                  | 10,459       |           |       | 8,481        |       |           | 10,540       |       |           | 8,481        |
| Total liabilities                  | 1,134,342    |           |       | 1,114,733    |       |           | 1,135,080    |       |           | 1,122,179    |
| Shareholders' equity               | 133,592      |           |       | 129,224      |       |           | 134,392      |       |           | 130,686      |
| Total                              | \$ 1,267,934 |           |       | \$ 1,243,957 |       |           | \$ 1,269,472 |       |           | \$ 1,252,865 |
| Net interest income                |              | \$ 23,045 |       |              |       | \$ 23,411 |              |       | \$ 11,328 |              |
| Net interest rate spread(1)        |              |           | 3.83% |              |       | 3.94%     |              |       | 3.72%     |              |
| Net interest margin(2)             |              |           | 3.97% |              |       | 4.13%     |              |       | 3.87%     |              |

(1) Net interest rate spread is the difference in the yield received on earning assets less the rate paid on interest-bearing liabilities.

(2) Net interest margin is the ratio of net interest income divided by average earning assets.

## Changes Due to Volume and Rate

Net interest income can be analyzed in terms of the impact of changes in rates and volumes. The following table illustrates the extent to which changes in interest rates and in the volume of average interest-earning assets and interest-bearing liabilities have affected the Corporation's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior rate); (ii) changes attributable to changes in rates (changes in rates multiplied by prior volume); and (iii) the net changes. For purposes of this table, changes that are not due solely to volume or rate changes have been allocated to these categories based on the respective percentage changes in average volume and rate. Due to the numerous simultaneous volume and rate changes during the periods analyzed, it is not possible to precisely allocate changes between volume and rates. In addition, average earning assets include non-accrual loans and no tax equivalent adjustments were made.

| (in thousands of dollars)   | Six Months Ended June 30, 2013 vs. 2012 |           |            | Three Months Ended June 30, 2013 vs. 2012 |           |         |
|---|---|-----------|------------|---|-----------|---------|
|   | Volume                                  | Rate      | Net        | Volume                                    | Rate      | Net     |
| Interest and dividends earned on:                                       |   |           |            |   |           |         |
| Loans   | \$2,825                                 | \$(3,170) | \$ (345)   | \$1,350                                   | \$(1,327) | \$ 23   |
| Taxable securities  | (435)                                   | (310)     | (745)      | (205)                                     | (171)     | (376)   |
| Tax-exempt securities   | (85)                                    | (5)       | (90)       | (47)                                      | (8)       | (55)    |
| Interest-bearing deposits   | (44)                                    | 1         | (43)       | (24)                                      | -         | (24)    |
| Total earning assets  | \$2,261                                 | \$(3,484) | \$ (1,223) | \$1,074                                   | \$(1,506) | \$(432) |
| Interest paid on:   |   |           |            |   |           |         |
| Demand deposits   | \$ 6                                    | \$ (2)    | \$ 4       | \$ 1                                      | \$ (2)    | \$ (1)  |
| Savings and insured money market deposits                               | 34                                      | (43)      | (9 )       | 18  | (5)       | 13      |
| Time deposits   | (152)                                   | (351)     | (503)      | (70)                                      | (161)     | (231)   |
| FHLB, other advances and securities sold under agreements to repurchase | (276)                                   | (73)      | (349)      | (121)                                     | (40)      | (161)   |
| Total interest-bearing liabilities                                      | \$ (388)                                | \$ (469)  | \$ (857)   | \$ (172)                                  | \$ (208)  | \$(380) |
| Net interest income   | \$2,649                                 | \$(3,015) | \$ (366)   | \$1,246                                   | \$(1,298) | \$ (52) |

## Provision for Loan Losses

The provision for loan losses for the six months ended June 30, 2013 totaled \$0.9 million compared with \$0.5 million for the six months ended June 30, 2012.

## Non-Interest Income

Non-interest income for the six months ended June 30, 2013 totaled \$8.5 million, a decrease of \$0.5 million, or 5.6%, compared with \$9.0 million for the same period in the prior year. The decline was due primarily to reductions of \$0.8 million in casualty gains from insurance reimbursements and \$0.3 million in net gain on securities transactions. These items were partially offset by increases in Wealth Management Group fee income, service charges on deposit accounts and net gain on sales of loans held for sale.

#### Non-Interest Expense

Non-interest expense for the six months ended June 30, 2013 totaled \$23.1 million, an increase of \$0.3 million, or 1.3%, compared with \$22.8 million for the same period in the prior year. The increase was due primarily to increases of \$0.4 million in salaries and wages and \$0.1 million in net occupancy expense. These items were primarily offset by decreases of \$0.2 million in marketing and advertising expense and \$0.1 million in amortization of intangible assets. The increase in salaries and wages was due primarily to compensation related to merit increases and incentive compensation.

#### Income Taxes

Income tax expense for the six months ended June 30, 2013 totaled \$2.5 million, a decrease of \$0.5 million, compared with \$3.0 million for the same period in the prior year. Income tax expense reflects an effective tax rate of 32.8% for the six months ended June 30, 2013 compared with 33.2% for the same period in the prior year. The decrease in the effective tax rate was due primarily to an increase in the relative percentage of tax exempt income to pre-tax income.

#### Comparison of Three Months Ended June 30, 2013 and 2012

##### Net Income

Net income for the three months ended June 30, 2013 was \$2.7 million, an increase of \$0.3 million, or 8.6%, compared with \$2.4 million for the three months ended June 30, 2012. Earnings per share for the three months ended June 30, 2013 was \$0.57 compared with \$0.53 for the three months ended June 30, 2012. Return on average assets and return on average equity for the three months ended June 30, 2013 were 0.84% and 7.92%, respectively, compared with 0.78% and 7.55%, respectively, for the same period in the prior year.

The increase in net income for the three months ended June 30, 2013 was due primarily to an increase of \$0.4 million in non-interest income and a reduction of \$0.5 million in non-interest expense. These items were partially offset by increases of \$0.4 million in the provision for loan losses and \$0.2 million in income taxes.

##### Net Interest Income

Net interest income for the three months ended June 30, 2013 totaled \$11.3 million, a decrease of \$0.1 million, or 0.5%, compared with \$11.4 million for the same period in the prior year. Net interest margin was 3.87% for the three months ended June 30, 2013 compared with 3.98% for the same period in the prior year. The decline in net interest income was due primarily to a 25 basis point decrease in the yield on interest-earning assets, partially offset by an increase of \$23.8 million in average earning assets. The decline in net interest margin was primarily due to yields on interest-earning assets decreasing at a faster rate than the cost of interest-bearing liabilities. The decrease in yield on interest-earning assets was attributable to a 62 basis point decrease in yield on loans, a result of loans continuing to reprice at current historically low market rates.

##### Provision for Loan Losses

The provision for loan losses for the three months ended June 30, 2013 totaled \$0.5 million compared with \$0.1 million for the three months ended June 30, 2012.

##### Non-Interest Income

Non-interest income for the three months ended June 30, 2013 totaled \$4.5 million, an increase of \$0.4 million, or 8.8%, compared with \$4.1 million for the same period in the prior year. The increase was due primarily to increases in Wealth Management fee income, service charges on deposit accounts and net gain on sales of loans held for sale.

### Non-Interest Expense

Non-interest expense for the three months ended June 30, 2013 totaled \$11.4 million, a decrease of \$0.5 million, or 4.1%, compared with \$11.9 million for the same period in the prior year. The decrease was primarily due to decreases of \$0.2 million in professional services and \$0.2 million in marketing and advertising expense. The decrease in professional services was due primarily to annual tax preparation costs for the Wealth Management Group recorded in the first quarter of 2013 compared to the second quarter of 2012 for the same costs.

### Income Taxes

Income tax expense for the three months ended June 30, 2013 totaled \$1.3 million, an increase of \$0.2 million, compared with \$1.1 million for the same period in the prior year. Income tax expense reflects an effective tax rate of 33.0% for the three months ended June 30, 2013 compared with 31.3% for the same period in the prior year. The increase in the effective tax rate was due primarily to a decrease in the relative percentage of tax exempt income to pre-tax income.

### Liquidity and Capital Resources

Liquidity management involves the ability to meet the cash flow requirements of deposit clients, 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 FHLB, which allows it to access borrowings that 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 \$85.4 million and \$104.5 million at June 30, 2013 and December 31, 2012, respectively. The Corporation also had a total of \$28.0 million of unsecured lines of credit with four different financial institutions, all of which was available at June 30, 2013 and December 31, 2012.

During the six months ended June 30, 2013, cash and cash equivalents decreased \$15.5 million. The major sources of cash included proceeds from sales, maturities, calls and principal reductions on securities totaling \$45.6 million, \$11.1 million provided by operating activities and an increase of \$10.2 million in deposits. These proceeds were used primarily to fund purchases of securities totaling \$36.5 million, a \$40.5 million net increase in loans and a \$3.3 million decrease in borrowings.

As of June 30, 2013, the Bank's Tier I leverage ratio, Tier I and total risk-based capital ratios were 8.59%, 11.07% and 12.56%, respectively. All of the ratios were in excess of those required to be considered well-capitalized under regulatory capital standards.

During the six months ended June 30, 2013, the Corporation declared cash dividends totaling \$0.52 per share compared with \$0.50 per share for the same period in the prior year.

### Interest Rate Risk

Management considers interest rate risk to be the most significant market risk for the Corporation. Market risk is the risk of loss from adverse changes in market prices and rates. Interest rate risk is the exposure to adverse changes in the net income of the Corporation as a result of changes in interest rates.

The Corporation's primary earnings source is net interest income, which is affected by changes in the level of interest rates, the relationship between rates, the impact of interest rate fluctuations on asset prepayments, the level and composition of deposits and liabilities, and credit quality of earning assets.



The Corporation's objectives in its asset and liability management are to maintain a strong, stable net interest margin, to utilize its capital effectively without taking undue risks, to maintain adequate liquidity, and to reduce vulnerability of its operations to changes in interest rates. The Corporation's Asset/Liability Committee ("ALCO") has the strategic responsibility for setting the policy guidelines on acceptable exposure to interest rate risk. These guidelines contain specific measures and limits regarding the risks, which are monitored on a regular basis. The ALCO is made up of the president and chief executive officer, the chief financial officer, the asset liability management officer, and other officers representing key functions.

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, 2013, it is estimated that an immediate 200-basis point decrease in interest rates would negatively impact the next 12 months net interest income by 8.86% and an immediate 200-basis point increase would negatively impact the next 12 months net interest income by 7.45%. Both are within the Corporation's policy guideline of 15%. 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 4.01% and 11.20%, respectively. Both are within the Corporation's policy guideline of 15%.

A related component of interest rate risk is the expectation that the market value of the Corporation's 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, 2013, it is estimated that an immediate 200-basis point decrease in interest rates would negatively impact the market value of the Corporation's capital account by 4.82% and an immediate 200-basis point increase in interest rates would negatively impact the market value by 4.75%. Both are within the Corporation's policy guideline of 15%. Management also modeled the impact to the market value of the Corporation's 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 the Corporation's capital of 2.92% and 7.70%, respectively. Both are within the Corporation's policy guideline of 15%.

Management does recognize the need for certain hedging strategies during periods of anticipated higher fluctuations in interest rates and the Funds Management Policy provides for limited use of certain derivatives in asset liability management. These strategies were not employed during the six months ended June 30, 2013.

#### Subsequent Event

On July 10, 2013, the Bank, the wholly-owned banking subsidiary of the Corporation entered into a Purchase and Assumption Agreement with Bank of America, National Association ("BOA") pursuant to which the Bank agreed to acquire certain assets and assume certain liabilities of six BOA branch offices located in Auburn, Cortland, Ithaca and Seneca Falls, New York. Subject to the terms of the Purchase Agreement, the Bank will acquire approximately \$261.0 million in deposits and \$1.6 million in loans, for a purchase price equal to the sum of a deposit premium of 1.5% based on the 30-day average balances prior to the close of the transaction, the aggregate net book value of all assets and accrued interest on the loans acquired. The Bank will not receive any loans that are past due 30 days or more on the closing date. The deposits acquired will initially be used to fund the purchase of short-term investments in the securities portfolio. The maturities and cash flows of these securities will be structured to provide funding of the anticipated deployment into new commercial and consumer loans expected to be originated in the near future. The transaction, which is subject to regulatory approval, is expected to close in the fourth quarter of 2013. Additional information concerning this transaction was included in the Corporation's Current Report on Form 8-K filed with the

SEC on July 12, 2013.

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## 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 Chief Financial Officer and Treasurer, who is the Corporation's principal financial officer, has evaluated the effectiveness of the Corporation's disclosure controls and procedures as of June 30, 2013 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, 2013. In addition, there have been no changes in the Corporation's internal control over financial reporting during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

For information related to this item, please see Note 9 to the Corporation's financial statements included herein.

## 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, 2012, filed with the Securities and Exchange Commission on March 15, 2013.

## 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 |
|-----------------------|----------------------------------|------------------------------|--|--|
| 4/1/13-4/30/13        | -                                | \$ -                         | -  | 121,906  |
| 5/1/13-5/31/13        | -                                | \$ -                         | -  | 121,906  |
| 6/1/13-6/30/13        | -                                | \$ -                         | -  | 121,906  |
| Quarter ended 6/30/13 | -                                | \$ -                         | -  | 121,906  |

(1) On December 19, 2012, the Corporation's Board of Directors approved a stock repurchase plan authorizing the purchase of up to 125,000 shares of the Corporation's outstanding common stock. This plan replaces the plan approved on November 2009, which expired in November 2012. Purchases may be made from time to time on the open-market or in private negotiated transactions and will be at the discretion of management. For the period ending June 30, 2013, a total of 3,094 shares had been purchased under this plan.



ITEM 6. EXHIBITS

The following exhibits are either filed with this Form 10-Q or are incorporated herein by reference. The Corporation's Securities Exchange Act File number is 000-13888.

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 May 16, 2012. (Filed as Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed with the SEC on May 18, 2012 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 Chief Financial Officer and Treasurer 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 Chief Financial Officer and Treasurer of the Registrant pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. §1350.\*

101.INS Instance Document\*

101.SCH XBRL Taxonomy Schema\*

101.CAL XBRL Taxonomy Calculation Linkbase\*

101.DEF XBRL Taxonomy Definition Linkbase\*

101.LAB XBRL Taxonomy Label Linkbase\*

101.PRE XBRL Taxonomy Presentation Linkbase\*

\* Filed herewith.



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

DATED: August 8, 2013      By: /s/ Ronald M. Bentley  
Ronald M. Bentley, President and Chief Executive Officer  
(Principal Executive Officer)

DATED: August 8, 2013      By: /s/ Mark A. Severson  
Mark A. Severson, Chief Financial Officer and Treasurer  
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

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