

EVANS BANCORP INC  
Form 10-Q  
May 06, 2011

**Table of Contents**

**United States  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

(Mark One)

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

**For quarterly period ended March 31, 2011**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 001-35021  
EVANS BANCORP, INC.**

(Exact name of registrant as specified in its charter)

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

16-1332767  
(I.R.S. Employer  
Identification No.)

14 -16 North Main Street, Angola, New York  
(Address of principal executive offices)

14006  
(Zip Code)

(716) 926-2000  
(Registrant's telephone number, including area code)  
Not applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer       Accelerated filer       Non-accelerated filer       Smaller reporting company

(Do not check if smaller reporting company)

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

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

Common Stock, \$.50 par value: 4,100,319 shares as of April 22, 2011

---

INDEX  
EVANS BANCORP, INC. AND SUBSIDIARIES

	PAGE
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	
<u>Unaudited Consolidated Balance Sheets March 31, 2011 and December 31, 2010</u>	1
<u>Unaudited Consolidated Statements of Income Three months ended March 31, 2011 and 2010</u>	2
<u>Unaudited Consolidated Statements of Stockholders Equity Three months ended March 31, 2011 and 2010</u>	3
<u>Unaudited Consolidated Statements of Cash Flows Three months ended March 31, 2011 and 2010</u>	4
<u>Notes to Unaudited Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	31
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	41
<u>Item 4. Controls and Procedures</u>	42
<u>PART II. OTHER INFORMATION</u>	
<u>Item 6. Exhibits</u>	42
<u>SIGNATURES</u>	43
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

---

**Table of Contents**

PART I FINANCIAL INFORMATION  
 ITEM 1 FINANCIAL STATEMENTS  
 EVANS BANCORP, INC. AND SUBSIDIARIES  
 UNAUDITED CONSOLIDATED BALANCE SHEETS  
 MARCH 31, 2011 AND DECEMBER 31, 2010  
 (in thousands, except share and per share amounts)

	March 31, 2011	December 31, 2010
<b>ASSETS</b>		
Cash and due from banks	\$ 13,553	\$ 13,467
Interest-bearing deposits at banks	17,567	255
Securities:		
Available for sale, at fair value (cost: \$93,940 at March 31, 2011; \$86,096 at December 31, 2010)	95,468	87,422
Held to maturity, at amortized cost (fair value: \$2,221 at March 31, 2011; \$2,130 at December 31, 2010)	2,235	2,140
FHLB and FRB common stock, at amortized cost and fair value	3,165	3,770
Loans and leases, net of allowance for loan and lease losses of \$10,482 in 2011 and \$10,424 in 2010	521,147	517,554
Properties and equipment, net of depreciation of \$12,368 in 2011 and \$12,054 in 2010	10,609	10,841
Goodwill	8,101	8,101
Intangible assets	1,038	1,168
Bank-owned life insurance	12,493	12,389
Other assets	14,335	14,416
<b>TOTAL ASSETS</b>	<b>\$ 699,711</b>	<b>\$ 671,523</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES</b>		
Deposits:		
Demand	\$ 99,444	\$ 98,016
NOW	43,457	32,683
Regular savings	263,854	249,410
Muni-vest	34,804	22,000
Time	143,588	142,348
Total deposits	585,147	544,457
Securities sold under agreement to repurchase	4,807	5,227
Other short-term borrowings	39	13,669
Other liabilities	12,055	11,776
Junior subordinated debentures	11,330	11,330

Long-term borrowings	22,000	22,000
Total liabilities	635,378	608,459
<b>CONTINGENT LIABILITIES AND COMMITMENTS</b>		
<b>STOCKHOLDERS EQUITY:</b>		
Common stock, \$.50 par value, 10,000,000 shares authorized; 4,094,147 and 4,081,960 shares issued and outstanding, respectively,	2,047	2,041
Capital surplus	40,720	40,660
Retained earnings	21,895	20,836
Accumulated other comprehensive loss, net of tax	(329)	(473)
Total stockholders equity	64,333	63,064
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 699,711</b>	<b>\$ 671,523</b>

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

PART I FINANCIAL INFORMATION  
 ITEM 1 FINANCIAL STATEMENTS  
 EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF INCOME  
 THREE MONTHS ENDED MARCH 31, 2011 AND 2010  
 (in thousands, except share and per share amounts)

	Three Months Ended March 31,	
	2011	2010
INTEREST INCOME		
Loans and leases	\$ 7,152	\$ 6,941
Interest bearing deposits at banks	4	
Securities:		
Taxable	486	403
Non-taxable	371	402
Total interest income	8,013	7,746
INTEREST EXPENSE		
Deposits	1,420	1,350
Other borrowings	215	238
Junior subordinated debentures	81	80
Total interest expense	1,716	1,668
NET INTEREST INCOME	6,297	6,078
PROVISION FOR LOAN AND LEASE LOSSES	488	1,214
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	5,809	4,864
NON-INTEREST INCOME		
Bank charges	386	511
Insurance service and fees	2,089	2,246
Data center income	239	234
Net gain (loss) on sales and calls of securities		(6)
Gain on loans sold	52	10
Bank-owned life insurance	103	108
Other	592	599
Total non-interest income	3,461	3,702
NON-INTEREST EXPENSE		
Salaries and employee benefits	3,904	3,608
Occupancy	777	771
Repairs and maintenance	159	182
Advertising and public relations	130	102
Professional services	402	414
Technology and communications	235	225
Amortization of intangibles	130	231
FDIC insurance	229	226
Other	639	692

Total non-interest expense	6,605	6,451
INCOME BEFORE INCOME TAXES	2,665	2,115
INCOME TAX PROVISION	790	668
NET INCOME	\$ 1,875	\$ 1,447
Net income per common share-basic	\$ 0.46	\$ 0.51
Net income per common share-diluted	\$ 0.46	\$ 0.51
Cash dividends per common share	\$ 0.20	\$ 0.20
Weighted average number of common shares outstanding	4,085,509	2,818,147
Weighted average number of diluted shares outstanding	4,096,170	2,823,559

*See Notes to Unaudited Consolidated Financial Statements*

2

---



**Table of Contents**

PART I FINANCIAL INFORMATION  
 ITEM 1 FINANCIAL STATEMENTS  
 EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY  
 THREE MONTHS ENDED MARCH 31, 2011 AND 2010  
 (in thousands, except share and per share amounts)

	<b>Common</b>	<b>Capital</b>	<b>Retained</b>	<b>Accumulated Other Comprehensive (Loss) Income</b>	<b>Total</b>
	<b>Stock</b>	<b>Surplus</b>	<b>Earnings</b>		
<b>Balance, January 1, 2010</b>	\$ 1,407	\$ 27,279	\$ 17,381	\$ (108)	\$ 45,959
Comprehensive income:					
Net Income			1,447		1,447
Unrealized gain on available-for-sale, net of reclassification of loss of (\$4) (after tax) securities, net of tax effect of (\$8)				25	25
Amortization of prior service cost and net loss net of tax effect of (\$13)				20	20
Total comprehensive income					1,492
Cash dividends (\$0.20 per common share)			(565)		(565)
Stock options expense		49			49
Issued 14,620 restricted shares	7	(7)			
<b>Balance, March 31, 2010</b>	\$ 1,414	\$ 27,321	\$ 18,263	\$ (63)	\$ 46,935
<b>Balance, January 1, 2011</b>	\$ 2,041	\$ 40,660	\$ 20,836	\$ (473)	\$ 63,064
Comprehensive income:					
Net Income			1,875		1,875
Unrealized gain on available-for-sale securities, net of tax effect of (\$78)				124	124

Amortization of prior service cost and net loss net of tax effect of (\$11)				20		20
Total comprehensive income						2,019
Cash dividends (\$0.20 per common share)			(816)			(816)
Excess tax benefit from stock-based compensation		9				9
Stock options expense		57				57
Issued 12,260 restricted shares	6		(6)			
<b>Balance, March 31, 2011</b>	\$ 2,047	\$ 40,720	\$ 21,895	\$	(329)	\$ 64,333

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

PART I FINANCIAL INFORMATION  
 ITEM 1 FINANCIAL STATEMENTS  
 EVANS BANCORP, INC. AND SUBSIDIARIES  
 UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 THREE MONTHS ENDED MARCH 31, 2011 AND 2010  
 (in thousands)

	Three Months Ended March 31,	
	2011	2010
<b>OPERATING ACTIVITIES:</b>		
Interest received	\$ 7,654	\$ 7,679
Fees received	3,590	3,765
Interest paid	(1,829)	(1,805)
Cash paid to employees and vendors	(5,985)	(5,079)
Income taxes paid	(299)	(1,021)
Proceeds from sale of loans held for resale	7,285	1,998
Originations of loans held for resale	(9,779)	(2,817)
Net cash provided by operating activities	637	2,720
<b>INVESTING ACTIVITIES:</b>		
Available for sales securities:		
Purchases	(10,029)	(38,305)
Proceeds from maturities and calls	2,655	29,254
Held to maturity securities:		
Purchases	(135)	
Proceeds from maturities and calls	39	
Additions to properties and equipment	(82)	(214)
Increase in loans, net of repayments	(2,327)	(9,725)
Net cash used in investing activities	(9,879)	(18,990)
<b>FINANCING ACTIVITIES:</b>		
Proceeds from borrowings		2,795
Repayments of borrowings	(14,050)	(61)
Net increase in deposits	40,690	11,332
Net cash provided by financing activities	26,640	14,066
Net increase (decrease) in cash and equivalents	17,398	(2,204)
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	13,722	12,983

End of period

\$ 31,120

\$ 10,779

(continued)

**Table of Contents**

(in thousands)

	Three Months Ended March 31,	
	2011	2010
<b>RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:</b>		
Net income	\$ 1,875	\$ 1,447
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	379	420
Deferred tax expense (benefit)	86	(31)
Provision for loan and lease losses	488	1,214
Net gain on sales of securities		6
Premium on loans sold	(52)	(10)
Stock options expense	57	49
Proceeds from sale of loans held for resale	7,285	1,998
Originations of loans held for resale	(9,779)	(2,817)
Changes in assets and liabilities affecting cash flow:		
Other assets	1,461	(490)
Other liabilities	(1,163)	934
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>\$ 637</b>	<b>\$ 2,720</b>

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

PART I-FINANCIAL INFORMATION

ITEM 1-FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED MARCH 31, 2011 AND 2010

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The accompanying consolidated financial statements are unaudited. In the opinion of management, all adjustments necessary for a fair presentation of the Company's financial position and results of operations for the interim periods have been made. Certain reclassifications have been made to the 2010 unaudited consolidated financial statements to conform to the presentation used in 2011.

The results of operations for the three month period ended March 31, 2011 are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited consolidated financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date of filing.

2. SECURITIES

The amortized cost of securities and their approximate fair value at March 31, 2011 and December 31, 2010 were as follows:

**Table of Contents**

	<b>March 31, 2011</b> (in thousands)			<b>Fair Value</b>
	<b>Amortized Cost</b>	<b>Unrealized</b>		
		<b>Gains</b>	<b>Losses</b>	
<b>Available for Sale:</b>				
Debt securities:				
U.S. government agencies	\$ 24,057	\$ 572	\$ (69)	\$ 24,560
States and political subdivisions	37,800	730	(107)	38,423
Total debt securities	\$ 61,857	\$ 1,302	\$ (176)	\$ 62,983
Mortgage-backed securities:				
FNMA	\$ 13,162	\$ 266	\$ (57)	\$ 13,371
FHLMC	9,667	139	(6)	9,800
GNMA	6,720	76	(13)	6,783
CMO S	2,534	19	(22)	2,531
Total mortgage-backed securities	\$ 32,083	\$ 500	\$ (98)	\$ 32,485
Total securities designated as available for sale	\$ 93,940	\$ 1,802	\$ (274)	\$ 95,468
<b>Held to Maturity:</b>				
Debt securities				
U.S. government agencies				
States and political subdivisions	2,235	19	(33)	2,221
Total securities designated as held to maturity	\$ 2,235	\$ 19	\$ (33)	\$ 2,221
Total securities	\$ 96,175	\$ 1,821	\$ (307)	\$ 97,689
<b>December 31, 2010</b> (in thousands)				
	<b>Unrealized</b>			<b>Fair Value</b>
	<b>Amortized Cost</b>	<b>Gains</b>	<b>Losses</b>	
<b>Available for Sale:</b>				
Debt securities:				
U.S. government agencies	\$ 23,130	\$ 609	\$ (95)	\$ 23,644
States and political subdivisions	35,796	726	(225)	36,297
Total debt securities	\$ 58,926	\$ 1,335	\$ (320)	\$ 59,941
Mortgage-backed securities:				
FNMA	\$ 10,207	\$ 320	\$ (65)	\$ 10,462
FHLMC	9,541	79	(53)	9,567

Edgar Filing: EVANS BANCORP INC - Form 10-Q

GNMA	4,763	38		4,801
CMO S	2,659	11	(19)	2,651
Total mortgage-backed securities	\$ 27,170	\$ 448	\$ (137)	\$ 27,481
Total securities designated as available for sale	\$ 86,096	\$ 1,783	\$ (457)	\$ 87,422
<b>Held to Maturity:</b>				
Debt securities				
U.S. government agencies				
States and political subdivisions	2,140	22	(32)	2,130
Total securities designated as held to maturity	\$ 2,140	\$ 22	\$ (32)	\$ 2,130
Total securities	\$ 88,236	\$ 1,805	\$ (489)	\$ 89,552

Available for sale securities with a total fair value of \$91.4 million and \$65.6 million at March 31, 2011 and December 31, 2010, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.



**Table of Contents**

The Company uses the Federal Home Loan Bank of New York ( FHLBNY ) as its primary source of overnight funds and also has several long-term advances with FHLBNY. The Company had a total of \$22.0 million and \$35.6 million in borrowed funds with FHLBNY at March 31, 2011 and December 31, 2010, respectively. The Company has placed sufficient collateral in the form of residential and commercial real estate loans at FHLBNY that meet FHLB collateral requirements. As a member of the Federal Home Loan Bank ( FHLB ) System, the Bank is required to hold stock in FHLBNY. The Bank held \$1.8 million and \$2.4 million in FHLBNY stock as of March 31, 2011 and December 31, 2010, respectively, at fair value.

The scheduled maturities of debt and mortgage-backed securities at March 31, 2011 are summarized below. All maturity amounts are contractual maturities. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call premiums.

	Amortized cost	Estimated fair value
	(in thousands)	
Debt securities available for sale:		
Due in one year or less	\$ 2,882	\$ 2,905
Due after one year through five years	19,539	19,957
Due after five years through ten years	23,063	23,448
Due after ten years	16,373	16,673
	61,857	62,983
Mortgage-backed securities available for sale	32,083	32,485
	\$ 93,940	\$ 95,468
Debt securities held to maturity:		
Due in one year or less	\$ 879	\$ 878
Due after one year through five years	446	448
Due after five years through ten years	280	290
Due after ten years	630	605
Mortgage-backed securities available for sale	\$ 2,235	\$ 2,221

Information regarding unrealized losses within the Company's available for sale securities at March 31, 2011 and December 31, 2010, is summarized below. The securities are primarily U.S. government-guaranteed agency securities or municipal securities. All unrealized losses are considered temporary and related to market interest rate fluctuations.

**Table of Contents**

	Less than 12 months		March 31, 2011 12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(in thousands)			
Available for Sale:						
Debt securities:						
U.S. government agencies	\$ 3,731	\$ (69)	\$	\$	\$ 3,731	\$ (69)
States and political subdivisions	6,709	(104)	305	(3)	7,014	(107)
Total debt securities	\$ 10,440	\$ (173)	\$ 305	\$ (3)	\$ 10,745	\$ (176)
Mortgage-backed securities:						
FNMA	\$ 4,413	\$ (57)	\$	\$	\$ 4,413	\$ (57)
FHLMC	3,730	(6)			3,730	(6)
GNMA	2,046	(13)			2,046	(13)
CMO S	1,982	(22)			1,982	(22)
Total mortgage-backed securities	\$ 12,171	\$ (98)	\$	\$	\$ 12,171	\$ (98)
Held To Maturity:						
Debt securities:						
States and political subdivisions	\$ 997	\$ (6)	\$ 466	\$ (27)	\$ 1,463	\$ (33)
Total temporarily impaired securities	\$ 23,608	\$ (277)	\$ 771	\$ (30)	\$ 24,379	\$ (307)
			December 31, 2010			
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(in thousands)			
Available for Sale:						
Debt securities:						
U.S. government agencies	\$ 3,705	\$ (95)	\$	\$	\$ 3,705	\$ (95)
States and political subdivisions	9,144	(225)			9,144	(225)
Total debt securities	\$ 12,849	\$ (320)	\$	\$	\$ 12,849	\$ (320)
Mortgage-backed securities:						
FNMA	\$ 3,113	\$ (65)	\$	\$	\$ 3,113	\$ (65)
FHLMC	7,897	(53)			7,897	(53)

Edgar Filing: EVANS BANCORP INC - Form 10-Q

CMO S	2,011	(19)			2,011	(19)
Total mortgage-backed securities	\$ 13,021	\$ (137)	\$	\$	\$ 13,021	\$ (137)
Held To Maturity: Debt securities: States and political subdivisions	\$	\$	\$	\$	\$	\$
Total temporarily impaired securities	\$ 25,870	\$ (457)	\$	\$	\$ 25,870	\$ (457)

**Table of Contents**

In regard to municipal securities, the Company's general investment policy is that in-state securities must be rated at least Moody's Baa (or equivalent) at the time of purchase. Out-of-state issues must be rated by Moody's at least Aa (or equivalent) at the time of purchase. The Company did not own any out-of-state municipal bonds at March 31, 2011 or December 31, 2010. Bonds rated below A are reviewed periodically to ensure their continued credit worthiness. While purchase of non-rated municipal securities is permitted, such purchases are limited to bonds issued by municipalities in the Company's general market area which, in the Company's judgment, possess no greater credit risk than Baa (or equivalent) bonds. The financial statements of the issuers of non-rated securities are reviewed by the Bank and a credit file of the issuers is kept on each non-rated municipal security with relevant financial information.

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

Management has assessed the securities available for sale in an unrealized loss position at March 31, 2011 and December 31, 2010 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities' amortized cost, and the financial condition of the issuer (primarily government or government-sponsored enterprises). In addition, management does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuers.

The Company has not recorded any other-than-temporary impairment charges in 2011 or 2010, the gross unrealized losses amounted to less than 0.5% of the total fair value of the securities portfolio at March 31, 2011 and December 31, 2010, and the gross unrealized loss position decreased by \$0.2 million from December 31, 2010 to March 31, 2011. Nevertheless, it remains possible that there could be deterioration in the asset quality of the securities portfolio in the future. The credit worthiness of the Company's portfolio is largely reliant on the ability of U.S. government sponsored agencies such as FHLB, Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), and Federal Home Loan Mortgage Corporation (FHLMC), and municipalities throughout New York State to meet their obligations. In addition, dysfunctional markets could materially alter the liquidity, interest rate, and pricing risk of the portfolio. The relatively stable past performance is not a guarantee for similar performance of the Company's securities portfolio going forward.

**3. FAIR VALUE MEASUREMENTS**

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

There are three levels of inputs to fair value measurements:

Level 1, meaning the use of quoted prices for identical instruments in active markets;

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

Level 3, meaning the use of unobservable inputs.

Observable market data should be used when available.



**Table of Contents****FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS**

The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a recurring basis at March 31, 2011 and December 31, 2010:

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Fair Value</b>
March 31, 2011				
Securities available-for-sale:				
U.S. government agencies	\$	\$ 24,560	\$	\$ 24,560
States and political subdivisions		38,423		38,423
Mortgage-backed securities		32,485		32,485
Mortgage servicing rights			435	435
December 31, 2010				
Securities available-for-sale:				
U.S. government agencies	\$	\$ 23,644	\$	\$ 23,644
States and political subdivisions		36,297		36,297
Mortgage-backed securities		27,481		27,481
Mortgage servicing rights			388	388

**Securities available for sale**

Fair values for securities are determined using independent pricing services and market-participating brokers. The pricing service and brokers use a variety of techniques to arrive at fair value including market maker bids, quotes, and pricing models. Inputs to their pricing models include recent trades, benchmark interest rates, spreads, and actual and projected cash flows. Management obtains a single market quote or price estimate for each security. Securities available for sale are classified as Level 2 in the fair value hierarchy as the valuation provided by the third-party provider uses observable market data.

**Mortgage servicing rights**

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSR's using a third-party pricing provider. The provider uses a combination of market and income valuation methodologies. All assumptions are market driven. Therefore, mortgage servicing rights are classified within Level 3 of the fair value hierarchy as the valuation is model driven and primarily based on unobservable inputs.

The following table summarizes the changes in fair value for items measured at fair value (Level 3) on a recurring basis using significant unobservable inputs:

Mortgage servicing rights	December 31, 2010	\$ 388
Gains included in earnings		4
Mortgage originations		43
Mortgage servicing rights	March 31, 2011	\$ 435

**FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS**

The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements. The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a nonrecurring basis at March 31, 2011 and December 31, 2010:

**Table of Contents**

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Fair Value</b>
March 31, 2011				
Impaired loans	\$	\$	\$ 8,813	\$ 8,813
December 31, 2010				
Impaired loans	\$	\$	\$ 7,787	\$ 7,787

**Impaired loans**

The Company evaluates and values impaired loans at the time the loan is identified as impaired, and the fair values of such loans are estimated using Level 3 inputs in the fair value hierarchy. Fair value is estimated based on the value of the collateral securing these loans. Collateral may consist of real estate and/or business assets including equipment, inventory and/or accounts receivable and the value of these assets is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, estimated costs to sell, and/or management's expertise and knowledge of the client and the client's business. The Company has an appraisal policy in which appraisals are obtained upon a loan being downgraded on the Company's internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired loans are either graded a 6 or 7 on the internal loan rating scale. Subsequent to the downgrade, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change in the condition of the collateral, or feedback from local appraisers. Impaired loans had a gross value of \$10.2 million, with a valuation allowance of \$1.4 million, at March 31, 2011, compared with a gross value of \$9.3 million, with a valuation allowance of \$1.5 million, at December 31, 2010.

**FAIR VALUE OF FINANCIAL INSTRUMENTS**

At March 31, 2011 and December 31, 2010, the estimated fair values of the Company's financial instruments, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis, were as follows:

	<b>March 31, 2011</b>		<b>December 31, 2010</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Carrying Amount</b>	<b>Fair Value</b>
	(in thousands)		(in thousands)	
Financial assets:				
Cash and cash equivalents	\$ 31,120	\$ 31,120	\$ 13,722	\$ 13,722
Available for sale securities	95,468	95,468	87,422	87,422
Held to maturity securities	2,235	2,221	2,140	2,130
FHLB and FRB stock	3,165	3,165	3,770	3,770
Loans and leases, net	521,147	530,764	517,554	535,338
Mortgage servicing rights	435	435	388	388
Financial liabilities:				
Deposits	\$ 585,147	\$ 585,082	\$ 544,457	\$ 544,889
Other borrowed funds and securities sold under agreements to repurchase	26,846	27,871	40,896	41,710
Junior subordinated debentures	11,330	11,330	11,330	11,330

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

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

**Securities available for sale.** Fair values for available-for-sale securities are determined using independent pricing



**Table of Contents**

services and market-participating brokers. The pricing service and brokers use a variety of techniques to arrive at fair value including market maker bids, quotes, and pricing models. Inputs to their pricing models include recent trades, benchmark interest rates, spreads, and actual and projected cash flows. Management obtains a single market quote or price estimate for each security. These quoted prices reflect current information based on orderly transactions. These are considered Level 2 inputs under ASC 820.

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

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

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

**Mortgage servicing rights.** Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSRs using a third-party pricing provider. The provider uses a combination of market and income valuation methodologies. All assumptions are market driven.

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

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

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

**Commitments to extend credit and standby letters of credit.** As described in Note 7 Contingent Liabilities and Commitments to these Unaudited Consolidated Financial Statements, the Company was a party to financial instruments with off-balance sheet risk at March 31, 2011 and December 31, 2010. Such financial instruments consist of commitments to extend permanent financing and letters of credit. If the options are exercised by the prospective borrowers, these financial instruments will become interest-earning assets of the Company. If the options expire, the Company retains any fees paid by the counterparty in order to obtain the commitment or guarantee. The fair value of commitments is estimated based upon fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate commitments, the fair value estimation takes into consideration an interest rate risk factor. The fair value of guarantees and letters of credit is based on fees currently charged for similar agreements. The fair value of these off-balance sheet items at March 31, 2011 and December 31, 2010 approximates the recorded amounts of the related fees, which are not considered material.

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

##### **Loans**

**Table of Contents**

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, generally are reported at their outstanding unpaid principal balances adjusted for unamortized deferred fees or costs. Interest income is accrued on the unpaid principal balance and is recognized using the interest method. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the effective yield method of accounting.

Loans become past due when the payment date has been missed. If payment has not been received within 30 days, then the loan is delinquent. Delinquent loans are placed into three categories; 30-59 days past due, 60-89 days past due, or 90+ days past due. Loans 90 or more days past due are considered non-performing.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent, unless the credit is well secured and in process of collection. If the credit is not well secured and in the process of collection, the loan is placed on non-accrual status and is subject to charge-off if collection of principal or interest is considered doubtful.

All interest due but not collected for loans that are placed on non-accrual status or charged off is reversed against interest income. The interest on these loans is accounted for on the cost-recovery method, until it again qualifies for an accrual basis. Any cash receipts on non-accrual loans reduce the carrying value of the loans. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current, the adverse circumstances which resulted in the delinquent payment status are resolved, and payments are made in a timely manner for a period of time sufficient to reasonably assure their future dependability.

The Bank considers a loan impaired when, based on current information and events, it is probable that it will be unable to collect principal or interest due according to the contractual terms of the loan. Commercial mortgage, commercial and industrial ( C&I ), and large balance leases (greater than \$100,000) are identified for evaluation and individually considered impaired. These loans and leases are assessed for any impairment. Loan impairment is measured based on the present value of expected cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Consumer loans and smaller balance leases are collectively evaluated for impairment. Since these loans and leases are not individually identified and evaluated, they are not considered impaired loans.

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

1-3-Pass: Risk Rated 1-3 loans are loans with a slight risk of loss. The loan is secured by collateral of sufficient value to cover the loan by an acceptable margin. The financial statements of the company demonstrate sufficient net worth and repayment ability. The company has established an acceptable credit history with the bank and typically has a proven track record of performance. Management is experienced, and has an at least average ability to manage the company. The industry has an average or less than average susceptibility to wide fluctuations in business cycles.

This risk rating includes all accruing consumer loans, including residential mortgages and home equities, that are less than 60 days past due.

4-Watch: Although generally acceptable, a higher degree of risk is evident in these watch credits. Obligor assessment factors may have elements which reflect marginally acceptable conditions warranting more careful review and analysis and monitoring.

The obligor's balance sheet reflects generally acceptable asset quality with some elements weak or marginally acceptable. Liquidity may be somewhat strained, but is at an acceptable level to support operations. Obligor may be fully leveraged with ratios higher than industry averages. High leverage is negatively impacting the company, leaving it vulnerable to adverse change. Inconsistent or declining capability to service existing debt requirements evidenced by debt service coverage temporarily below or near acceptable level. The margin of collateral may be adequate, but declining or fluctuating in value. Company management may be unproven, but

capable. Rapid expansion or acquisition may increase leverage or reduce cash flow.

**Table of Contents**

Negative industry conditions or weaker management could also be characteristic. Proper consideration should be given to companies in a high growth phase or in development business segments that may not have achieved sustainable earnings.

Obligors demonstrate sufficient financial flexibility to react to and positively address the root cause of the adverse financial trends without significant deviations from their current business strategy. The rating is also used for borrowers that have made significant progress in resolving their financial weaknesses.

5-O.A.E.M. (Other Assets Especially Mentioned): Special Mention ( SM ) A special mention asset has potential weaknesses that warrant management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. SM assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

SM assets have potential weaknesses that may, if not checked or corrected, weaken the asset or inadequately protect the institution's position at some future date. These assets pose elevated risk, but their weakness does not yet justify a substandard classification. Borrowers may be experiencing adverse operating trends (declining revenues or margins) or an ill proportioned balance sheet (e.g. increasing inventory without an increase in sales, high leverage, tight liquidity).

Adverse economic or market conditions, such as interest rate increases or the entry of a new competitor, may also support a special mention rating.

Nonfinancial reasons for rating a credit exposure special mention include management problems, pending litigation, an ineffective loan agreement or other material structural weakness, and any other significant deviation from prudent lending practices.

The SM rating is designed to identify a specific level of risk and concern about asset quality. Although an SM asset has a higher probability of default than a pass asset, its default is not imminent.

This risk rating includes the pool of consumer loans, including residential mortgages and home equities, that are 60-89 days past due.

6-Substandard: A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Substandard assets have a high probability of payment default, or they have other well-defined weaknesses. They require more intensive supervision by bank management.

Substandard assets are generally characterized by current or expected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization. Repayment may depend on collateral or other credit risk subsidies. For some substandard assets, the likelihood of full collection of interest and principal may be in doubt; such assets should be placed on non-accrual. Although substandard assets in the aggregate will have distinct potential for loss, an individual asset's loss potential does not have to be distinct for the asset to be rated substandard. These loans are periodically reviewed and tested for impairment.

This risk rating includes the pool of consumer loans, including residential mortgages and home equities, that are 90 or more days past due or in non-accrual status.

7-Doubtful: An asset classified doubtful has all the weaknesses inherent in one classified 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.

**Table of Contents**

A doubtful asset has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification of loss is deferred.

Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack the resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, the perfection of liens on additional collateral, the valuation of collateral, and refinancing.

Generally, pending events should be resolved within a relatively short period and the ratings will be adjusted based on the new information. Because of high probability of loss, non-accrual accounting treatment is required for doubtful assets.

8-Loss: Assets classified loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the assets have absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be achieved in the future.

With loss assets, the underlying borrowers are often in bankruptcy, have formally suspended debt repayments, or have otherwise ceased normal business operations. Once an asset is classified loss, there is little prospect of collecting either its principal or interest. When access to collateral, rather than the value of the collateral, is a problem, a less severe classification may be appropriate. However, management should not maintain an asset on the balance sheet if realizing its value would require long-term litigation or other lengthy recovery efforts. Losses are to be recorded in the period an obligation becomes uncollectible.

**Leases**

The Bank's leasing operations consists principally of the leasing of various types of small ticket commercial equipment. The Company follows ASC Topic 840, Leases, for all of its direct financing leases. The net investment in direct financing leases is the sum of all minimum lease payments and estimated residual values, less unearned income, net of the remaining mark. In the third quarter of 2009, the Company announced its intention to sell the leasing portfolio. As a result, the Company classified the leasing portfolio as held-for-sale and marked the portfolio down to its fair market value as of June 30, 2009. As of September 30, 2009, management decided to service the portfolio to maturity and transferred it to held-for-investment. The carrying value of the leasing portfolio amounted to \$12.4 million and \$15.5 million at March 31, 2011 and December 31, 2010, respectively. The CQI used for leases are delinquency and accruing status. The leasing CQI's are discussed in more detail in the *Credit Quality Indicators* section of this footnote.

**Loan and Lease Portfolio Composition**

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

**Table of Contents**

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
	(in thousands)	
Mortgage loans on real estate:		
Residential Mortgages	\$ 69,815	\$ 69,958
Commercial and multi-family	274,138	261,371
Construction-Residential	1,412	1,320
Construction-Commercial	25,397	32,332
Home equities	53,736	53,120
 Total real estate loans	 424,498	 418,101
Direct financing leases	12,449	15,475
Commercial loans	92,120	91,445
Consumer loans	1,996	2,458
Other	302	252
Net deferred loan origination costs	264	247
 Total gross loans	 531,629	 527,978
 Allowance for loan losses	 (10,482)	 (10,424)
 Loans, net	 \$ 521,147	 \$ 517,554

*Residential Mortgages:* The Company originates adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a mortgage. These loans are collateralized by owner-occupied properties located in the Company's market area. They are amortized over 10 to 30 years. Loans on one-to-four-family residential real estate are mostly originated in amounts of no more than 80% of appraised value or have private mortgage insurance. Mortgage title insurance and hazard insurance are normally required. Construction loans have a unique risk, because they are secured by an incomplete dwelling.

Due to the lack of foreclosure activity and absence of any ongoing litigation, the Company has no accrual for loss contingencies or potential costs associated with foreclosure-related activities.

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three month period ended March 31, 2011, the Bank sold mortgages to FNMA totaling \$7.3 million, as compared with \$2.0 million sold during the three month period ended March 31, 2010. At March 31, 2011, the Bank had a loan servicing portfolio principal balance of \$49.8 million upon which it earns servicing fees, as compared with \$44.2 million at December 31, 2010. The value of the mortgage servicing rights for that portfolio was \$0.4 million at March 31, 2011 and December 31, 2010. Residential mortgage loans held-for-sale were \$1.4 million at March 31, 2011, compared with \$2.9 million at December 31, 2010. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

*Commercial and Multi-Family Mortgages:* Commercial real estate loans are made to finance the purchases of real estate with completed structures or in the midst of being constructed. These commercial real estate loans are secured by first liens on the real estate, which may include apartments, hotels, retail stores or plazas, healthcare facilities, and other non-owner-occupied facilities. These loans are less risky than commercial and industrial loans, since they are secured by real estate and buildings. The Company offers commercial mortgage loans with up to an 80% LTV ratio for up to 20 years on a variable and fixed rate basis. Many of these mortgage loans either mature or are subject to a rate call after three to five years. The Company's underwriting analysis includes credit verification, independent

appraisals, a review of the borrower's financial condition, and the underlying cash flows. These loans are typically originated in amounts of no more than 80% of the appraised value of the property. Construction loans have a unique risk, because they are secured by an incomplete dwelling.

*Home Equities:* The Company originates home equity lines of credit and second mortgage loans (loans secured by a second lien position on owner-occupied one-to-four-family residential real estate). These loans carry a higher risk than first mortgage residential loans as they are in a second position relating to collateral. Risk is reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower's financial condition,



**Table of Contents**

and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate. *Direct Financing Leases:* From January 2005 to April 2009 the Company originated direct financing leases of commercial small-ticket general business equipment to companies located throughout the United States. These leases carry a high risk of loss. As a result of the increase in credit risks, poor performance in the portfolio, the lack of strategic fit with the Company's community banking philosophy, and with the intention of reallocating capital back to its core business, management announced its exit from the national leasing business in April 2009. As a result of management's decision to sell the portfolio a mark-to-market adjustment of \$7.2 million was made on June 30, 2009. The mark was charged off against the allowance. The portfolio was subsequently placed back into held-for-investment as of September 30, 2009 after management determined that a greater value for the portfolio would be realized by keeping it and servicing it to maturity rather than selling it. The portfolio was re-classified as held-for-investment using the same \$7.2 million mark. Since that time, leases that are determined to have zero value have been applied to the remaining mark, rather than charged off through the allowance. There is an allowance for lease losses for \$1.5 million at March 31, 2011.

*Commercial and Industrial Loans:* These loans generally include term loans and lines of credit. Such loans are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and equipment purchases. As a general practice, a collateral lien is placed on equipment or other assets owned by the borrower. These loans carry a higher risk than commercial real estate loans by the nature of the underlying collateral, which can be business assets such as equipment and accounts receivable. To reduce the risk, management also attempts to secure real estate as collateral and obtain personal guarantees of the borrowers. To further reduce risk and enhance liquidity, these loans generally carry variable rates of interest, re-pricing in three- to five-year periods, and have a maturity of ten years or less. Lines of credit generally carry floating rates of interest (e.g., prime plus a margin).

*Consumer Loans:* The Company funds a variety of consumer loans, including direct automobile loans, recreational vehicle loans, boat loans, aircraft loans, home improvement loans, and personal loans (collateralized and uncollateralized). Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging up to five years, based upon the nature of the collateral and the size of the loan. The majority of consumer loans are underwritten on a secured basis using the underlying collateral being financed. A minimal amount of loans are unsecured, which carry a high risk of loss.

*Other Loans:* These loans include \$0.1 million and \$0.3 million at March 31, 2011 and December 31, 2010, respectively, of overdrawn deposit accounts classified as loans.

Net loan commitment fees or costs for commitment periods greater than one year are deferred and amortized into fee income or other expense on a straight-line basis over the commitment period.

**Credit Quality Indicators**

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

**Table of Contents****March 31, 2011**

(in thousands)

<b>Corporate Credit</b>					
<b>Exposure</b>	<b>By</b>	<b>Commercial</b>	<b>Commercial Real</b>	<b>Total Commercial</b>	
<b>Credit Rating</b>		<b>Real Estate Construction</b>	<b>Estate Other</b>	<b>Real Estate</b>	<b>Commercial</b>
3		\$ 19,441	\$ 222,248	\$ 241,689	\$ 61,931
4		2,211	36,929	39,140	19,329
5		2,276	5,442	7,718	5,090
6		1,469	9,519	10,988	4,847
7					923
<b>Total</b>		<b>\$ 25,397</b>	<b>\$ 274,138</b>	<b>\$ 299,535</b>	<b>\$ 92,120</b>

**December 31, 2010**

(in thousands)

<b>Corporate Credit</b>					
<b>Exposure</b>	<b>By</b>	<b>Commercial</b>	<b>Commercial Real</b>	<b>Total Commercial</b>	
<b>Credit Rating</b>		<b>Real Estate Construction</b>	<b>Estate Other</b>	<b>Real Estate</b>	<b>Commercial</b>
3		\$ 25,584	\$ 212,825	\$ 238,409	\$ 60,728
4		2,703	37,393	40,096	19,692
5		2,565	2,176	4,741	4,699
6		1,480	8,977	10,457	4,966
7					1,360
<b>Total</b>		<b>\$ 32,332</b>	<b>\$ 261,371</b>	<b>\$ 293,703</b>	<b>\$ 91,445</b>

The Company's risk ratings are monitored by the individual relationship managers and changed as deemed appropriate after receiving updated financial information from the borrowers or deterioration or improvement in the performance of a loan is evident in the customer's payment history. Each commercial relationship is individually assigned a risk rating. The Company also maintains a loan review process that monitors the management of the Company's commercial loan portfolio by the relationship managers. The Company's loan review function reviews at least 40% of the commercial and commercial mortgage portfolio annually.

The Company's consumer loans, including residential mortgages and home equity loans, are not individually risk rated or reviewed in the Company's loan review process. Consumers are not required to provide the Company with updated financial information as a commercial customer is. Consumer loans are also smaller in balances. Given the lack of updated information since the initial underwriting of the loan and small size of individual loans, the Company uses the delinquency status as the credit quality indicator for consumer loans. The delinquency table is shown below. The Company does not lend to sub-prime borrowers. Unless the loan is well secured and in the process of collection, all consumer loans that are more than 90 days past due are placed in non-accrual status.

Similar to consumer loans, direct financing leases are evaluated in pools according to delinquency and accruing status rather than assigned risk ratings. Given the comparable lower credit quality of the leasing portfolio, leases are rarely kept in accruing status beyond 30 days past due. Non-accrual leases are assigned a reserve percentage based on the historical loss history of the Company's non-accrual lease portfolio. Evaluating non-accruing leases as a pool is appropriate as they are small-balance and homogeneous in nature. On a quarterly basis, large leases (defined as leases greater than \$100,000 in balances) are evaluated for any deterioration not readily apparent through payment

performance. If any risk factors become apparent during the review such as deteriorating financial performance for the customer's business or requests for a restructuring from the original terms of the contract, management places those large leases that are performing from a payment perspective but have some indications of credit deterioration

**Table of Contents**

into a second pool. These large leases with additional risk are assigned a reserve percentage reflective of the additional risk characteristics while taking into account the adequate payment performance. The Company does have two large leases in which it performs specific impairment tests because they contain significantly different risk characteristics than the remaining leasing portfolio. One of the leases is with a local borrower with whom the Bank has a developed relationship and a restructuring plan is in place. The second lease is with a large public company that recently declared bankruptcy. The Company is considered a secured creditor in the bankruptcy and has received payments as scheduled in 2011. While the two large leases have characteristics of troubled credits and are classified as nonaccrual, management does not believe these two leases have similar characteristics as compared with the remaining lease portfolio. Management believes appropriate reserves have been established on an individual basis for the two leases. All other leases are placed in a third pool and assigned a reserve percentage commensurate with the credit history of the Company's leasing portfolio, delinquency trends, non-accrual trends, charge-off trends, and general macro-economic factors.

**Past Due Loans and Leases**

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

	<b>March 31, 2011</b>							<b>Non-accruing Loans and Leases</b>
	<b>(in thousands)</b>							
	<b>30-59 days</b>	<b>60-89 days</b>	<b>90+ days</b>	<b>Total Past Due</b>	<b>Current Balance</b>	<b>Total Balance</b>	<b>90+ Days Accruing</b>	
Commercial and industrial	\$ 218	\$	\$ 1,696	\$ 1,914	\$ 90,206	\$ 92,120	\$	\$ 1,808
Residential real estate:								
Residential	554	654	188	1,396	68,419	69,815		708
Construction			184	184	1,228	1,412		184
Commercial real estate:								
Commercial	2,618		2,835	5,453	268,685	274,138		6,546
Construction		625	843	1,468	23,929	25,397		1,468
Home equities	261	68	158	487	53,249	53,736		439
Direct financing leases	277	241	1,071	1,589	10,860	12,449		2,127
Consumer	207	1	23	231	1,765	1,996	20	149
Other					566	566		
<b>Total Loans</b>	<b>\$ 4,135</b>	<b>\$ 1,589</b>	<b>\$ 6,998</b>	<b>\$ 12,722</b>	<b>\$ 518,907</b>	<b>\$ 531,629</b>	<b>\$ 20</b>	<b>\$ 13,429</b>

**Table of Contents****December 31, 2010**

(in thousands)

	<b>30-59 days</b>	<b>60-89 days</b>	<b>90+ days</b>	<b>Total Past Due</b>	<b>Current Balance</b>	<b>Total Balance</b>	<b>90+ Days Accruing</b>	<b>Non- accruing Loans and Leases</b>
Commercial and industrial	\$ 403	\$ 200	\$ 1,827	\$ 2,430	\$ 89,015	\$ 91,445	\$	\$ 2,203
Residential real estate:								
Residential	684	393	662	1,739	68,219	69,958		696
Construction			186	186	1,134	1,320		186
Commercial real estate:								
Commercial	351	4,196	2,014	6,561	254,810	261,371		5,724
Construction	6,277		1,655	7,932	24,400	32,332	805	850
Home equities	437		118	555	52,565	53,120		256
Direct financing leases	609	224	1,578	2,411	13,064	15,475	1	2,930
Consumer	83	135	190	408	2,050	2,458		276
Other	1			1	498	499		
<b>Total Loans</b>	<b>\$ 8,845</b>	<b>\$ 5,148</b>	<b>\$ 8,230</b>	<b>\$ 22,223</b>	<b>\$ 505,755</b>	<b>\$ 527,978</b>	<b>\$ 806</b>	<b>\$ 13,121</b>

**Allowance for loan and lease losses**

The provision for loan and lease losses represents the amount charged against the Bank's earnings to maintain an allowance for probable loan and lease losses inherent in the portfolio based on management's evaluation of the loan and lease portfolio at the balance sheet date. Factors considered by the Bank's management in establishing the allowance include: the collectability of individual loans and leases, current loan and lease concentrations, charge-off history, delinquent loan and lease percentages, the fair value of the collateral, input from regulatory agencies, and general economic conditions.

On a quarterly basis, management of the Bank meets to review and determine the adequacy of the allowance for loan and lease losses. In making this determination, the Bank's management analyzes the ultimate collectability of the loans and leases in its portfolio by incorporating feedback provided by the Bank's internal loan and lease staff, an independent internal loan and lease review function and information provided by examinations performed by regulatory agencies.

The analysis of the allowance for loan and lease losses is composed of two components: specific credit allocation and general portfolio allocation. The specific credit allocation includes a detailed review of each impaired loan and allocation is made based on this analysis. Factors may include the appraisal value of the collateral, the age of the appraisal, the type of collateral, the performance of the loan to date, the performance of the borrower's business based on financial statements, and legal judgments involving the borrower. The general portfolio allocation consists of an assigned reserve percentage based on the historical loss experience and other quantitative and qualitative factors of the loan or lease category.

The general portfolio allocation is segmented into pools of loans with similar characteristics. Separate pools of loans include loans pooled by loan grade and by portfolio segment. The Company does not have sufficient meaningful data to perform a traditional loss migration analysis and thus has implemented alternative procedures. Loans graded 5 or worse ( criticized loans ) that exceed a material balance threshold are evaluated by the Company's credit department to determine if the collateral for the loan is worth less than the loan. All of these shortfalls are added together and

divided by the respective loan pool to calculate the quantitative factor applied to the respective pool. These loans are not considered impaired because the cash flow of the customer and the payment history of the loan suggest that it is not probable that the Company will be unable to collect the full amount of principal and interest as contracted and are thus still accruing interest.

Loans that are graded 4 or better ( non-criticized loans ) are reserved in separate loan pools in the general portfolio

**Table of Contents**

allocation. A weighted average 5-year historical charge-off ratio by portfolio segment is calculated and applied against these loan pools.

For both the criticized and non-criticized loan pools in the general portfolio allocation, additional qualitative factors are applied. The qualitative factors applied to the general portfolio allocation reflect management's evaluation of various conditions. The conditions evaluated include the following: industry and regional conditions; seasoning of the loan and lease portfolio and changes in the composition of and growth in the loan and lease portfolio; the strength and duration of the business cycle; existing general economic and business conditions in the lending areas; credit quality trends in non-accruing loans and leases; timing of the identification of downgrades; historical loan and lease charge-off experience; and the results of bank regulatory examinations. Due to the nature of the loans, the criticized loan pools carry significantly higher qualitative factors than the non-criticized pools.

Direct financing leases are segregated from the rest of the loan portfolio in determining the appropriate allowance for that portfolio segment. Unlike the loan portfolio, the Company does not have sufficient historical loss data to perform a migration analysis for non-accruing leases. Management periodically updates this analysis by examining the non-accruing lease portfolio at different points in time and studying what percentage of the non-accruing portfolio ends up being charged off. There are selected large leases in non-accruing status which carry different characteristics than the rest of the portfolio. The Company has more information on these particular lessees. The underwriting for these leases was different due to the size of the leases and the subsequent servicing of these leases was also more intensive. Due to the elevated level of information on these leases, the Company is able to specifically analyze these leases and allocate an appropriate specific reserve based on the information available including cash flow, payment history, and collateral value. These selected large leases are not considered when performing the migration analysis. All of the remaining leases not in non-accrual are allocated a reserve based on several factors including: delinquency and non-accrual trends, charge-off trends, and national economic conditions.

Changes in the allowance for loan and lease losses for the three months ended March 31, 2011 and 2010 are as follows:

	<b>2011</b>	<b>2010</b>
	(in thousands)	
Beginning balance, January 1	\$ 10,424	\$ 6,971
Provision for loan and lease losses	488	1,214
Recoveries	7	4
Loans and leases charged off	(437)	(19)
Ending balance, March 31	\$ 10,482	\$ 8,170

The following tables summarize the allowance for loan and lease losses according to portfolio segment, as of March 31, 2011:

**Table of Contents**

(in thousands)	Commercial Real Estate		Consumer	Residential		Finance		Total
	Commercial Mortgages*	Mortgages*	^	Mortgages*	HELOC	Leases	Unallocated	
<b>Allowance for loan and lease losses:</b>								
Beginning balance	\$ 3,435	\$ 4,252	\$ 29	\$ 548	\$ 540	\$ 1,471	\$ 149	\$ 10,424
Charge-offs	(433)		(4)					(437)
Recoveries	3		3		1			7
Provision	325	132	9	16	6			488
Ending balance	\$ 3,330	\$ 4,384	\$ 37	\$ 564	\$ 547	\$ 1,471	\$ 149	\$ 10,482
<b>Allowance for loan and lease losses:</b>								
Individually evaluated for impairment	\$ 546	\$ 768	\$ 12	\$	\$	\$ 50	\$	\$ 1,376
Collectively evaluated for impairment	2,784	\$ 3,585	\$ 25	564	547	1,421	149	9,075
Loans acquired with deteriorated credit quality		31						31
Total	\$ 3,330	\$ 4,384	\$ 37	\$ 564	\$ 547	\$ 1,471	\$ 149	\$ 10,482
<b>Loans and leases:</b>								
Ending balance:								
Individually evaluated for impairment	\$ 1,808	\$ 7,860	\$ 62	\$	\$	\$ 336	\$	\$ 10,066
Collectively evaluated for impairment	90,312	291,521	2,152	71,227	53,736	12,113		521,061
Loans acquired with deteriorated credit quality		154	84					238
Total	\$ 92,120	\$ 299,535	\$ 2,298	\$ 71,227	\$ 53,736	\$ 12,449	\$	\$ 531,365

\* Includes construction loans



^ Includes other loans

**Impaired Loans and Leases**

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

		Unpaid		At March 31, 2011 Average		Interest	Interest
	Recorded	Principal	Related	Recorded	Interest	Income	Income
	Investment	Balance	Allowance	Investment	Income	Foregone	Recognized
				(in thousands)			
<b>With no related allowance recorded:</b>							
Commercial and industrial	\$ 363	\$ 364	\$	\$ 364	\$	2	\$
Residential real estate:							
Residential							
Construction							
Commercial real estate:							
Commercial	1,374	1,516		1,375		39	
Construction	1,468	1,497		1,054		14	3
Home equities							
Direct financing leases							
Consumer	84	244		153		3	
Other							
Total impaired loans and leases	\$ 3,289	\$ 3,621	\$	\$ 2,946	\$	58	\$ 3

**Table of Contents**

	Unpaid		At March 31, 2011 Average		Interest	Interest
	Recorded Investment	Principal Balance	Related Allowance	Recorded Investment (in thousands)	Income Foregone	Income Recognized
<b>With a related allowance recorded:</b>						
Commercial and industrial	\$ 1,445	\$ 2,115	\$ 546	\$ 1,864	\$ 36	\$
Residential real estate:						
Residential						
Construction						
Commercial real estate:						
Commercial	5,172	5,988	799	4,897	98	
Construction						
Home equities						
Direct financing leases	336	347	50	552	9	
Consumer	62	62	12	62		
Other						
<b>Total impaired loans and leases</b>	<b>\$ 7,015</b>	<b>\$ 8,512</b>	<b>\$ 1,407</b>	<b>\$ 7,375</b>	<b>\$ 143</b>	<b>\$</b>

	Unpaid		At March 31, 2011 Average		Interest	Interest
	Recorded Investment	Principal Balance	Related Allowance	Recorded Investment (in thousands)	Income Foregone	Income Recognized
<b>Total</b>						
Commercial and industrial	\$ 1,808	\$ 2,479	\$ 546	\$ 2,228	\$ 38	\$
Residential real estate:						
Residential						
Construction						
Commercial real estate:						
Commercial	6,546	7,504	799	6,272	137	
Construction	1,468	1,497		1,054	14	3
Home equities						
Direct financing leases	336	347	50	552	9	
Consumer	146	306	12	215	3	
Other						
<b>Total impaired loans and leases</b>	<b>\$ 10,304</b>	<b>\$ 12,133</b>	<b>\$ 1,407</b>	<b>\$ 10,321</b>	<b>\$ 201</b>	<b>\$ 3</b>

**Table of Contents**

	At December 31, 2010		
	Recorded	Unpaid	Related
	Investment	Principal	Allowance
		Balance	
		(in thousands)	
Commercial and industrial	\$ 2,203	\$ 2,610	\$ 803
Residential real estate:			
Residential			
Construction			
Commercial real estate:			
Commercial	5,724	6,515	616
Construction	850	867	15
Home equities			
Direct financing leases	522	524	78
Consumer			
Other			
<b>Total impaired loans and leases</b>	<b>\$ 9,299</b>	<b>\$ 10,516</b>	<b>\$ 1,512</b>

At December 31, 2010, the Company did not have any impaired loans for which there is no related allowance for credit loss. The interest income in the preceding tables as of March 31, 2011 was interest income recognized prior to these loans and leases being identified as impaired and placed on non-accrual. The Company did not recognize any interest income on those loans and leases while they were on non-accrual and impaired.

**Non-performing loans and leases**

The following table sets forth information regarding non-performing loans and leases as of the dates specified:

**Table of Contents**

	March 31, 2011	December 31, 2010 (in thousands)
Non-accruing loans and leases:		
Mortgage loans on real estate:		
Residential mortgages	\$ 708	\$ 696
Commercial and multi-family	6,546	5,724
Construction-residential	184	186
Construction-commercial	1,468	850
Home equities	439	256
Total real estate loans	9,345	7,712
Direct financing leases	2,127	2,930
Commercial loans	1,808	2,203
Consumer loans	149	276
Other		
Total non-accruing loans and leases	\$ 13,429	\$ 13,121
Accruing loans 90+ days past due	20	806
Total non-performing loans and leases	\$ 13,449	\$ 13,927
Total non-performing loans and leases to total assets	1.92%	2.07%
Total non-performing loans and leases to total loans and leases	2.53%	2.64%

**Troubled debt restructurings**

The Company had \$6.0 million in loans and leases that were restructured in a troubled debt restructuring ( TDR ) at March 31, 2011, compared with \$2.5 million at December 31, 2010. \$4.4 million and \$1.3 million of those balances were in non-accrual status at March 31, 2011 and December 31, 2010, respectively. Any TDR that is placed on non-accrual is not reverted back to accruing status until the borrower makes timely payments as contracted for at least six months. Those loans and leases that are in accruing status have shown evidence of performance for at least six months as of March 31, 2011 and December 31, 2010. None of the restructurings are covered under loss-sharing arrangements with the FDIC or were made under a government assistance program. These restructurings were allowed in an effort to maximize the Company's ability to collect on loans and leases where borrowers were experiencing financial difficulty. Previous to the first quarter of 2011, most of the Company's TDRs have been in the leasing portfolio. The most common modification and concession made by the Company is to permit the borrower to skip a lease payment and add an additional payment to the end of the lease. The increase in the first quarter of 2011 in commercial real estate TDR's is due to the addition of a single loan in the amount of \$3.5 million. The loan, which was placed on nonaccrual in the fourth quarter of 2010 and considered impaired as of December 31, 2010, was restructured to a reduced payment structure in the first quarter of 2011. Modifications made to loans in a troubled debt restructuring did not have a material impact on the Company's net income for the quarters ended March 31, 2011 and 2010. The general practice of the Bank is to work with borrowers so that they are able to pay back their loan or lease in full. If a borrower continues to be delinquent or cannot meet the terms of a TDR, the loan or lease will be placed on

non-accrual or charged off. TDRs are reserved similarly to the rest of the portfolio in that their CQIs are considered. The reserve for an impaired TDR is based upon the present value of the future expected cash flows discounted at the loan's original effective rate or upon the fair value of the collateral less costs to sell, if the loan is deemed collateral dependent. There were no commitments to lend additional funds to debtors owing loans or leases whose terms have been modified in TDRs. The following table summarizes the loans and leases that were classified as troubled debt restructurings as of the dates indicated.

**Table of Contents**

	March 31, 2011	December 31, 2010 (in thousands)
Commerical and industrial	\$ 362	\$ 166
Residential real estate:		
Residential	280	
Construction		
Commerical real estate:		
Commercial and multi family	3,622	139
Construction		
Home equities	66	68
Direct financing leases	1,685	2,155
Consumer loans		
Other		
Total troubled restructured loans and leases	\$ 6,015	\$ 2,528

**Covered Loans and the Related Allowance**

On July 24, 2009, the Bank entered into a definitive purchase and assumption agreement with the FDIC under which the Bank assumed approximately \$51.0 million in liabilities, consisting almost entirely of deposits, and purchased substantially all of the assets of Waterford Village Bank. The loan portfolio acquired in the transaction was \$42.0 million. The loans acquired in that acquisition are referred to as covered loans because they are covered by a loss sharing agreement with the FDIC. The agreement calls for the FDIC to reimburse the Bank for 80% of losses up to \$5.6 million and to reimburse the Bank for 95% of losses beyond that threshold. At acquisition, the Company marked the covered loan portfolio to its market value and the allowance for loan and lease losses related to the covered loans was zero. Since acquisition, management has provisioned for any incremental increases in estimated credit losses due to deterioration in specific loans or increased risk factors on pools of loans. As a result of the FDIC guarantees, the provision for loan and lease losses and the allowance for loan and lease losses at March 31, 2011 and December 31, 2010 are presented net of FDIC guarantees related to covered loans. The following table depicts the allowance for loan and lease losses related to covered loans as of March 31, 2011 and December 31, 2010:

	March 31, 2011	December 31, 2010 (in thousands)
Covered loans	\$ 31,832	\$ 34,157
Incremental estimated credit losses since acquisition	624	593
FDIC guarantee	(501)	(474)
Allowance for loan and lease losses	\$ 123	\$ 119

**5. PER SHARE DATA**

The common stock per share information is based upon the weighted average number of shares outstanding during each period. The Company had 10,661 and 5,412 dilutive shares for the three month periods ended March 31, 2011 and 2010, respectively.

Potential common shares that would have the effect of increasing diluted earnings per share are considered to be anti-dilutive and not included in calculating diluted earnings per share. For the three months periods ended March 31,

2011 and 2010, there were approximately 153,150 and 162,447 shares, respectively, that were not included in calculating diluted earnings per share because their effect was anti-dilutive.

27

---

**Table of Contents****6. SEGMENT INFORMATION**

The Company is comprised of two primary business segments, banking and insurance agency activities. The following tables set forth information regarding these segments for the three month periods ended March 31, 2011 and 2010.

	<b>Three Months Ended March 31, 2011</b>		
	(in thousands)		
	<b>Banking</b>	<b>Insurance</b>	
	<b>Activities</b>	<b>Agency</b>	<b>Total</b>
		<b>Activities</b>	
Net interest income (expense)	\$ 6,327	\$ (30)	\$ 6,297
Provision for loan and lease losses	488		488
Net interest income (expense) after provision for loan and lease losses	5,839	(30)	5,809
Non-interest income	1,372		1,372
Insurance service and fees		2,089	2,089
Non-interest expense	5,282	1,323	6,605
Income before income taxes	1,929	736	2,665
Income tax provision	506	284	790
Net income	\$ 1,423	\$ 452	\$ 1,875

	<b>Three Months Ended March 31, 2010</b>		
	(in thousands)		
	<b>Banking</b>	<b>Insurance</b>	
	<b>Activities</b>	<b>Agency</b>	<b>Total</b>
		<b>Activities</b>	
Net interest income (expense)	\$ 6,127	\$ (49)	\$ 6,078
Provision for loan and lease losses	1,214		1,214
Net interest income (expense) after provision for loan and lease losses	4,913	(49)	4,864
Non-interest income	1,456		1,456
Insurance service and fees		2,246	2,246
Non-interest expense	4,977	1,474	6,451
Income before income taxes	1,392	723	2,115
Income tax provision	389	279	668
Net income	\$ 1,003	\$ 444	\$ 1,447

**7. CONTINGENT LIABILITIES AND COMMITMENTS**

The unaudited consolidated financial statements do not reflect various commitments and contingent liabilities, which arise in the normal course of business, and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities consist of commitments to extend credit and standby letters of credit. A



summary of the Bank's commitments and contingent liabilities is as follows:

28

---

**Table of Contents**

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
	(in thousands)	
Commitments to extend credit	\$ 131,638	\$ 136,549
Standby letters of credit	3,570	3,687
Total	\$ 135,208	\$ 140,236

Commitments to extend credit and standby letters of credit include some exposure to credit loss in the event of nonperformance of the customer. The Bank's credit policies and procedures for credit commitments and financial guarantees are the same as those for extensions of credit that are recorded on the Company's unaudited consolidated balance sheets. Because these instruments have fixed maturity dates, and because they may expire without being drawn upon, they do not necessarily represent cash requirements of the Bank. The Bank has not incurred any losses on its commitments during the past two years.

Certain lending commitments for construction residential mortgage loans are considered derivative instruments under the guidelines of GAAP. The changes in the fair value of these commitments, due to interest rate risk, are not recorded on the consolidated balance sheets as the fair value of these derivatives is not considered material.

The Company is subject to possible litigation proceedings in the normal course of business. As of March 31, 2011 and December 31, 2010, there were no claims pending against the Company that management considered material.

#### **8. NET PERIODIC BENEFIT COSTS**

On January 31, 2008, the Bank froze its defined benefit pension plan. The plan covered substantially all Company employees. The plan provides benefits that are based on the employees' compensation and years of service. Under the freeze, eligible employees will receive at retirement the benefits already earned through January 31, 2008, but have not accrued any additional benefits since then. As a result, service cost is no longer incurred.

The Bank used an actuarial method of amortizing prior service cost and unrecognized net gains or losses which result from actual expense and assumptions being different than those that are projected. The amortization method the Bank used recognized the prior service cost and net gains or losses over the average remaining service period of active employees.

The Bank also maintains a nonqualified supplemental executive retirement plan covering certain members of the Company's senior management. The Bank uses an actuarial method of amortizing unrecognized net gains or losses which result from actual expense and assumptions being different than those that are projected. The amortization method the Bank uses recognizes the net gains or losses over the average remaining service period of active employees.

The following table presents the net periodic cost for the Bank's defined benefit pension plan and supplemental executive retirement plan for the three month periods ended March 31, 2011 and 2010:

**Table of Contents**

	<b>Three months ended March 31,</b>			
	(in thousands)			
	<b>Pension Benefits</b>		<b>Supplemental Executive Retirement Plan</b>	
	2011	2010	2011	2010
Service cost	\$		\$	
Interest cost		54		47
Expected return on plan assets		(57)		(49)
Amortization of prior service cost			22	22
Amortization of the net loss		7	3	2
Net periodic cost	\$	4	\$	117
		\$	14	\$
			117	112

**9. RECENT ACCOUNTING PRONOUNCEMENTS**

Accounting Standards Update ( ASU ) 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. The main objective of the ASU is to clarify guidance in identifying restructuring of receivables that constitute troubled debt restructurings for a creditor so that there is more consistent application of U.S. GAAP for debt restructurings. The ASU clarifies the guidance on a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. The new guidance is effective for interim periods beginning after June 15, 2011. The Company will adopt ASU 2011-02 for the three month period ended September 30, 2011. The Company is evaluating whether the new guidance will have any impact on the Company's identification of troubled debt restructurings.

**Table of Contents****ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This Quarterly Report on Form 10-Q may contain certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), that involve substantial risks and uncertainties. When used in this report, or in the documents incorporated by reference herein, the words anticipate, believe, estimate, expect, intend, may, plan, seek, and similar expressions identify such forward-looking statements. These forward-looking statements include statements regarding the Company's business plans, prospects, growth and operating strategies, statements regarding the asset quality of the Company's loan and investment portfolios, and estimates of the Company's risks and future costs and benefits.

These forward-looking statements are based largely on the expectations of the Company's management and are subject to a number of risks and uncertainties, including but not limited to general economic conditions, either nationally or in the Company's market areas, that are worse than expected; increased competition among depository or other financial institutions; inflation and changes in the interest rate environment that reduce the Company's margins or reduce the fair value of financial instruments; changes in laws or government regulations affecting financial institutions, including changes in regulatory fees and capital requirements; the Company's ability to enter new markets successfully and capitalize on growth opportunities; the Company's ability to successfully integrate acquired entities; changes in accounting pronouncements and practices, as adopted by financial institution regulatory agencies, the Financial Accounting Standards Board and the Public Company Accounting Oversight Board; changes in consumer spending, borrowing and saving habits; changes in the Company's organization, compensation and benefit plans; and other factors discussed elsewhere in this Quarterly Report on Form 10-Q, as well as in the Company's periodic reports filed with the SEC, in particular the Risk Factors discussed in Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010. Many of these factors are beyond the Company's control and are difficult to predict.

Because of these and other uncertainties, the Company's actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. Forward-looking statements speak only as of the date they are made. The Company undertakes no obligation to publicly update or revise forward-looking information, whether as a result of new, updated information, future events or otherwise.

**APPLICATION OF CRITICAL ACCOUNTING ESTIMATES**

The Company's Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q are prepared in accordance with U.S. GAAP and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the Company's Unaudited Consolidated Financial Statements and Notes. These estimates, assumptions and judgments are based on information available as of the date of the Unaudited Consolidated Financial Statements. Accordingly, as this information changes, the Unaudited Consolidated Financial Statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments, and as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated in good faith by management primarily through the use of internal cash flow modeling techniques. Refer to Note 3 Fair Value Measurements to the Company's Unaudited Consolidated Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q for further detail on fair value measurement.

Significant accounting policies followed by the Company are presented in Note 1 Organization and Summary of Significant Accounting Policies to the Audited Consolidated Financial Statements included in Item 8 in its Annual  
31

---

**Table of Contents**

Report on Form 10-K for the year ended December 31, 2010. These policies, along with the disclosures presented in the other Notes to the Company's Audited Consolidated Financial Statements contained in its Annual Report on Form 10-K and in this financial review, provide information on how significant assets and liabilities are presented in the Company's Unaudited Consolidated Financial Statements and how those values are determined.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan and lease losses and valuation of goodwill to be the accounting areas that require the most subjective or complex judgments, and as such, could be most subject to revision as new information becomes available.

**Allowance for Loan and Lease Losses**

The allowance for loan and lease losses represents management's estimate of probable losses in the Company's loan and lease portfolio. Determining the amount of the allowance for loan and lease losses is considered a critical accounting estimate because it requires significant judgment on the part of management and the use of estimates related to the amount and timing of expected future cash flows on impaired loans and leases, estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan and lease portfolio also represents the largest asset type on the Company's Unaudited Consolidated Balance Sheets. Note 1 to the Audited Consolidated Financial Statements included in Item 8 in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, describes the methodology used to determine the allowance for loan and lease losses.

**Goodwill**

The amount of goodwill reflected in the Company's Unaudited Consolidated Financial Statements is required to be tested by management for impairment on at least an annual basis. The test for impairment of goodwill on the identified reporting unit is considered a critical accounting estimate because it requires judgment on the part of management and the use of estimates related to the growth assumptions and market multiples used in the valuation model. The goodwill impairment testing is typically performed annually on December 31<sup>st</sup>. No impairment charges were incurred in the most recent test and the fair value of the tested reporting unit substantially exceeded its fair value.

**ANALYSIS OF FINANCIAL CONDITION****Loan and Lease Activity**

Total loans and leases grew to \$531.6 million at March 31, 2011, reflecting a \$3.6 million or 0.7% increase from December 31, 2010. The national direct financing lease portfolio declined \$3.1 million during the first quarter to \$12.4 million at March 31, 2011 as the Company ceased lease originations in the second quarter of 2009 and is winding down the portfolio and exiting this business line. The national direct financing lease portfolio currently comprises 2.3% of the Company's total loan and lease portfolio, down from 2.9% at December 31, 2010.

Core loans, defined as total loans less leases, were \$519.2 million at March 31, 2011, a \$6.7 million, or 1.3% increase from \$512.5 million at December 31, 2010. This equates to a 5.2% annualized growth rate. The annualized growth rate in the fourth quarter of 2010 for the core loan portfolio was 21.9%. The large amount of loans closed in the fourth quarter of 2010 left the loan pipeline relatively lighter to start 2011.

Loans secured by real estate were \$424.5 million at March 31, 2011, an increase of \$6.4 million or 1.5% from December 31, 2010. The strongest growth was in commercial and multi-family real estate loans, which increased \$12.7 million or 4.9% in the first quarter of 2011. Some of that growth is attributable to commercial construction loans converting to permanent loans in the first quarter. Commercial construction loans decreased \$6.9 million in the quarter to \$25.4 million at March 31, 2011.

Residential mortgages decreased slightly from \$70.0 million at December 31, 2010 to \$69.8 million at March 31, 2011. The sluggish national real estate market has kept long-term fixed rate mortgage loan rates near all-time historic lows. As a result, the Company has sold the majority of its originated residential mortgage loans. This, along with prepayments from existing customers re-financing their homes, has resulted in the slight decrease in

**Table of Contents**

residential mortgage balances in the first quarter of 2011. Residential mortgage originations have increased sharply with \$9.0 million in originations in the 2011 first quarter, compared with \$4.1 million in last year's first quarter, as the Company has added mortgage loan officers in the past year.

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three month period ended March 31, 2011, the Bank sold mortgages to FNMA totaling \$7.3 million, as compared with \$2.0 million sold during the three month period ended March 31, 2010. At March 31, 2011, the Bank had a loan servicing portfolio principal balance of \$49.8 million upon which it earns servicing fees, as compared with \$44.2 million at December 31, 2010. The value of the mortgage servicing rights for that portfolio was \$0.4 million at March 31, 2011 and December 31, 2010. Residential mortgage loans held-for-sale were \$1.4 million at March 31, 2011, compared with \$2.9 million at December 31, 2010. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

The Company continues to focus on C&I lending as a way to diversify its loan portfolio, which has historically experienced strong growth rates in real estate loans. The C&I portfolio grew \$0.7 million, or 0.8% in the first quarter of 2011. This equates to a 3.2% annualized growth rate. The Company has recently bolstered its C&I potential with recent hirings and improvements to its cash management capabilities. However, the Company faces the headwinds of a low growth economy and a very competitive local market.

**Leasing Portfolio**

As noted above, management made the strategic decision in April 2009 to exit the national direct financing lease business and market the portfolio for sale. This decision resulted in the classification of the leasing portfolio as held-for-sale and the portfolio being marked to its market value at June 30, 2009. The mark-to-market adjustment was \$7.2 million. At September 30, 2009, management determined to keep the lease portfolio and service it to maturity, terminated its plans to actively market the portfolio for sale, and the portfolio was placed back into held-for-investment at the revised carrying amount as of June 30, 2009. The difference between the principal value and the carrying value, initially created by the mark-to-market adjustment at June 30, 2009, reduces over time as individual leases deteriorate, become uncollectible, and are written off. The allowance for lease losses was zero at June 30, 2009 when the portfolio was classified as held-for-sale and reported at its fair market value. With the portfolio classified as held-for-investment at March 31, 2011, the portfolio has been evaluated in accordance with the Company's normal credit review policies in determining the appropriate allowance for lease losses. During the first quarter of 2011, \$0.6 million in leases were deemed uncollectible and the difference between the principal value and carrying value of the leases declined from \$1.5 million to \$0.9 million. The first quarter write-offs were flat when compared to the fourth quarter of 2010, but down from \$1.1 million in the first quarter of 2010. Non-performing leases of \$2.1 million at March 31, 2011 declined from \$2.9 million at December 31, 2010 and \$2.7 million at March 31, 2010. With both leasing write-offs and non-accruing lease balances declining, management determined that there was no need to add to the allowance for leasing losses at March 31, 2011. The following table illustrates the write-off and allowance activity related to the leasing portfolio over the past five quarters.

**Table of Contents**

	(\$ in thousands)				
	2011		2010		
	March 31,	December 31,	September 30,	June 30,	March 31,
Leasing Principal Balance	\$ 13,339	\$ 16,968	\$ 20,869	\$ 25,142	\$ 29,788
Mark	(890)	(1,493)	(2,124)	(2,469)	(3,084)
Leasing Carrying Value	\$ 12,449	\$ 15,475	\$ 18,745	\$ 22,673	\$ 26,704
Mark-to-Market Adjustment	\$ 1,493	\$ 2,124	\$ 2,469	\$ 3,084	\$ 4,159
Net Write-Offs	(603)	(631)	(345)	(615)	(1,075)
Remaining Mark	\$ 890	\$ 1,493	\$ 2,124	\$ 2,469	\$ 3,084
	For the three months ended				
	2011		2010		
	March 31,	December 31,	September 30,	June 30,	March 31,
Allowance for lease losses	\$ 1,471	\$ 1,077	\$ 772	\$ 772	\$ 772
Provision for leases		394	305		772
Leasing net charge-offs					
Allowance for lease losses	\$ 1,471	\$ 1,471	\$ 1,077	\$ 772	\$ 772
Total mark plus allowance	\$ 2,361	\$ 2,964	\$ 3,201	\$ 3,241	\$ 3,856
Mark + allowance/leasing principal balance	17.70%	17.47%	15.34%	12.89%	12.94%

**Credit Quality of Loan Portfolio**

Total non-performing loans and leases, defined as accruing loans and leases greater than 90 days past due and non-accrual loans and leases, totaled \$13.4 million, or 2.53% of total loans and leases outstanding, at March 31, 2011, compared with \$13.9 million, or 2.64% of total loans and leases outstanding at December 31, 2010. In the first quarter of 2011, two commercial real estate loans with a balance of \$0.9 million, one commercial construction loan with a balance of \$0.6 million, and two home equity loans with a balance of \$0.2 million were moved into non-accrual. The total impairment on those loans was \$0.1 million and was included in the provision for loan and lease losses in the three month period ended March 31, 2011.

The \$1.7 million in loans moved into non-performing loans and leases was offset by a decrease in non-accruing leases of \$0.8 million in the first quarter, the payoff of a \$0.8 million loan that was 90 days past due and still accruing at December 31, 2010, and the partial charge-off of three non-performing loan relationships for \$0.4 million. The decrease in leasing nonaccruals resulted mostly from charge-offs of leases in nonaccrual at December 31, 2010 and fewer leases being placed on nonaccrual in the first quarter of 2011. There was also a \$0.1 million pay-down on the Company's largest non-accruing lease.

The allowance for loan and lease losses totaled \$10.5 million or 1.97% of total loans and leases outstanding at March 31, 2011, as compared with \$10.4 million or 1.97% of total loans and leases outstanding at December 31, 2010. The increase in the allowance over the prior year resulted from a \$0.5 million provision for loan and lease losses offset by net charge-offs of \$0.4 million in the three month period ended March 31, 2011. The provision resulted from an



upward trend in loans categorized as special mention (risk rating of 5) or substandard (risk rating of 6) in the Company's internal credit ratings, loan growth, and an increase in specific reserves for impaired loans. The \$0.4 million in net charge-offs equates to a 0.33% annualized ratio as a percentage of net loans and leases. This compares with a 0.06% ratio in the fourth quarter of 2010 and 0.01% in the first quarter of 2010. The charge-offs in the first quarter of 2011 stemmed from partial charge-offs of three C&I loan relationships that were already identified as impaired and on nonaccrual and adequately reserved as of December 31, 2010.

The coverage ratio of the allowance for loan and lease losses to non-performing loans and leases increased from 72% to 78% at March 31, 2010 and 2011, respectively. There are two factors that significantly influence these ratios. The first factor is the covered loan portfolio acquired in the Waterford transaction discussed in Note 4 to the

**Table of Contents**

Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. The second factor is the leasing portfolio, which carries significantly higher risk, but also has the remaining mark to consider as depicted in the table above. The following table depicts the allowance and non-performing ratios by segregating the covered and non-covered loan portfolios and the leasing portfolio as of the following dates:

	March 31, 2011 (\$ in thousands)					
	Balance	Allowance for loan and lease losses	Non-performing loans and leases	Allowance for loan and lease losses/Total loans and leases	Non-performing loans and leases/Total loans and leases	Allowance for loan and lease losses/Non-performing loans and leases
Non-covered loans	\$ 487,348	\$ 8,888	\$ 8,990	1.82%	1.84%	98.87%
Covered loans	31,832	123	2,332	0.39%	7.33%	5.27%
Leases	12,449	1,471	2,127	11.82%	17.09%	69.16%
<b>Total</b>	<b>\$ 531,629</b>	<b>\$ 10,482</b>	<b>\$ 13,449</b>	<b>1.97%</b>	<b>2.53%</b>	<b>77.94%</b>

	December 31, 2010 (\$ in thousands)					
	Balance	Allowance for loan and lease losses	Non-performing loans and leases	Allowance for loan and lease losses/Total loans and leases	Non-performing loans and leases/Total loans and leases	Allowance for loan and lease losses/Non-performing loans and leases
Non-covered loans	\$ 478,346	\$ 8,834	\$ 8,515	1.85%	1.78%	103.75%
Covered loans	34,157	119	2,482	0.35%	7.27%	4.80%
Leases	15,475	1,471	2,930	9.51%	18.93%	50.20%
<b>Total</b>	<b>\$ 527,978</b>	<b>\$ 10,424</b>	<b>\$ 13,927</b>	<b>1.97%</b>	<b>2.64%</b>	<b>74.85%</b>

**Investing Activities**

Total securities were \$100.9 million at March 31, 2011, reflecting a \$7.6 million, or 8.1%, increase from \$93.3 million at December 31, 2010. The increase in securities balances is a result of deposit growth out-pacing loan growth in the first quarter of 2011. Management utilized some of the excess funds raised to purchase investment securities.

Compared with December 31, 2010, as of March 31, 2011, the Company added \$1.0 million in U.S. government-sponsored agency bonds, \$2.1 million in tax-advantaged municipal bonds, and \$5.0 million in U.S. government-sponsored mortgage-backed securities. Interest-bearing deposits at other banks, which consist of

overnight funds kept at correspondent banks, increased from \$0.3 million at December 31, 2010 to \$17.6 million at March 31, 2011. \$21.6 million of the deposit growth in the first quarter is attributable to increases in municipal deposits. As most of that municipal deposit growth is likely seasonal due to inflows from tax receipts, management decided to keep the funds invested short-term. Securities and interest-bearing deposits at correspondent banks made up 16.8% of the Bank's total average interest earning assets in the first quarter of 2011, compared with 17.1% in the fourth quarter of 2010.

The Company's highest concentration in its securities portfolio continues to be in its tax-advantaged municipal bonds, which comprised 41.6% of the total portfolio at March 31, 2011, compared with 42.9% at December 31, 2010. The concentration in government-sponsored mortgage-backed securities increased from 30.7% at December 31, 2010 to 33.3% at March 31, 2011. U.S. government-sponsored agency bonds of various types comprised 25.1% of the portfolio at March 31, 2011 versus 26.4% at December 31, 2010. As a member of both the Federal Reserve System and FHLBNY, the Bank is required to hold stock in those entities. The credit quality of the securities portfolio as a whole is believed to be strong as the portfolio is in an overall unrealized net gain position, with no individual securities in a significant unrealized loss position. With interest rates at historic lows, the net unrealized

**Table of Contents**

gain position of the investment portfolio increased from \$1.3 million at December 31, 2010 to \$1.5 million at March 31, 2011.

The Company monitors extension and prepayment risk in the securities portfolio to limit potential exposures. The average expected life of the securities portfolio was 3.9 years as of March 31, 2011 compared with 4.0 years as of December 31, 2010. Available-for-sale securities with a total fair value of \$91.4 million and \$65.6 million at March 31, 2011 and December 31, 2010, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law. The Company has no direct exposure to subprime mortgages, nor does the Company hold private mortgage-backed securities, credit default swaps, or FNMA or FHLMC preferred stock investments in its investment portfolio.

**Funding Activities**

Total deposits at March 31, 2011 were \$585.1 million, reflecting a \$40.7 million, or 7.5%, increase from December 31, 2010. \$21.6 million of the growth occurred in municipal deposits. There is typically a seasonal spike in municipal deposits in the first quarter of the year due to tax receipt inflows at the municipalities. The municipal deposit growth was across various deposit categories: demand (\$0.4 million), NOW (\$7.3 million), regular savings (\$1.1 million), and muni-vest savings (\$12.8 million). Demand deposits at March 31, 2011 were \$99.4 million, reflecting a \$1.4 million or 1.4% increase from December 31, 2010. Demand deposit balances fluctuate day-to-day based on the high volume of transactions normally associated with the demand product, and therefore average demand deposit growth is a better measure of sustained growth. Average demand deposits during the three month period ended March 31, 2011 of \$101.8 million were 4.0% higher than the fourth quarter of 2010 and 21.2% higher than the prior year's first quarter. Most of the Company's growth in demand deposits has come from commercial customers.

The Company's retail deposit growth vehicle continues to be the complementary Better Checking and Better Savings products, which are included in the NOW and regular savings deposit categories on the Company's balance sheet, respectively. The Better Checking product, introduced in the fourth quarter of 2009, is unique in the Bank's Western New York footprint as it pays a premium interest rate as a reward to customers who demonstrate a deep relationship with the Bank as evidenced by regular use of their debit card, use of direct deposit, and electronic statements. Overall, Better Checking deposits increased \$3.4 million for the first three months of the year. Regular savings deposits increased \$14.4 million, or 5.8%, in the first quarter of 2011. That growth is mostly a result of an increase in Better Savings deposits, offset by decreases in legacy savings products.

Time deposits were \$143.6 million at March 31, 2011, an increase of \$1.3 million, or 0.9%, from \$142.3 million at December 31, 2010. While some long-term rates have risen recently, time deposit rates remain near historic lows. As a result, customers have continued to show a preference for liquid savings products over time deposits.

Short-term borrowings, which typically include the Bank's overnight line of credit and other advances with the FHLBNY and other short-term notes, decreased to near zero (\$39 thousand) at March 31, 2011 from \$13.7 million at December 31, 2010. Because the Company's deposit growth has outpaced its loan growth this year, the Bank's outstanding overnight line of credit with FHLBNY, was reduced to zero at March 31, 2011. Long-term borrowings at March 31, 2011 remained unchanged from the December 31, 2010 balance.

**Table of Contents****ANALYSIS OF RESULTS OF OPERATIONS****Average Balance Sheet**

The following tables present the significant categories of the assets and liabilities of the Company, interest income and interest expense, and the corresponding yields earned and rates paid for the periods indicated. The assets and liabilities are presented as daily averages. The average loan and lease balances include both performing and non-performing loans and leases. Investments are included at amortized cost. Yields are presented on a non-tax-equivalent basis.

	Three Months Ended March 31, 2011			Three Months Ended March 31, 2010		
	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate
	(dollars in thousands)			(dollars in thousands)		
<b>ASSETS</b>						
Interest-earning assets:						
Loans and leases, net	\$ 518,246	\$ 7,152	5.52%	\$ 484,241	\$ 6,941	5.73%
Taxable securities	57,442	486	3.38%	41,809	403	3.86%
Tax-exempt securities	38,536	371	3.85%	39,564	402	4.06%
Interest bearing deposits at banks	8,456	4	0.19%	2,333		0.06%
Total interest-earning assets	622,680	\$ 8,013	5.15%	567,947	\$ 7,746	5.46%
Non interest-earning assets:						
Cash and due from banks	15,388			11,217		
Premises and equipment, net	10,760			9,243		
Other assets	36,000			35,267		
Total Assets	\$ 684,828			\$ 623,674		
<b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>						
Interest-bearing liabilities:						
NOW	\$ 38,469	\$ 106	1.10%	\$ 19,638	\$ 37	0.75%
Regular savings	256,158	410	0.64%	231,761	403	0.70%
Muni-Vest savings	24,616	29	0.47%	30,913	40	0.52%
Time deposits	143,177	875	2.44%	140,381	870	2.48%
Other borrowed funds	27,129	211	3.11%	40,373	232	2.30%
Junior subordinated debentures	11,330	81	2.86%	11,330	80	2.82%
Securities sold U/A to repurchase	6,387	4	0.25%	7,190	6	0.33%
Total interest-bearing liabilities	507,266	\$ 1,716	1.35%	481,586	\$ 1,668	1.39%

Noninterest-bearing liabilities:			
Demand deposits	101,798	83,995	
Other	11,737	11,004	
Total liabilities	\$ 620,801	\$ 576,585	
Stockholders' equity	64,027	47,089	
Total Liabilities and Equity	\$ 684,828	\$ 623,674	
Net interest earnings	\$ 6,297	\$ 6,078	
Net interest margin		4.05%	4.28%
Interest rate spread		3.80%	4.07%

**Table of Contents****Net Income**

The Company had net income of \$1.9 million, or \$0.46 per diluted share, in the first quarter of 2011, an increase from net income of \$1.4 million, or \$0.51 per diluted share, in the first quarter of 2010. The change in net income reflects a provision for loan and lease losses of \$0.5 million in the first quarter of 2011, which was \$0.7 million lower than the first quarter of 2010. The 2010 first quarter included a \$0.8 million provision for the Company's leasing portfolio, compared with zero provision for the leasing portfolio in this year's first quarter. The return on average equity was 11.71% for the first quarter of 2011, compared with 12.29% in the first quarter of 2010. The decline in diluted earnings per share and return on average equity reflects the impact of the Company's common stock offering in May 2010 that resulted in the issuance of 1.2 million shares of common stock which generated \$13.4 million in net proceeds to the Company.

**Supplemental Reporting of Non-GAAP Results of Operations**

To provide investors with greater understanding of the Company's operating results, in addition to the results measured in accordance with U.S. generally accepted accounting principles (GAAP), the Company provides supplemental reporting on net operating income, which excludes items that management believes to be non-operating in nature. Specifically, net operating income excludes gains and losses on the sale and call of securities, non-cash impairment and amortization of acquisition-related goodwill and intangible assets. This non-GAAP information is being disclosed because management believes that providing these non-GAAP financial measures provides investors with information useful in understanding the Company's financial performance, its performance trends, and financial position. While the Company's management uses these non-GAAP measures in its analysis of the Company's performance, this information should not be viewed as a substitute for financial results determined in accordance with GAAP or considered to be more important than financial results determined in accordance with GAAP, nor is it necessarily comparable with non-GAAP measures which may be presented by other companies. The reconciliation of net operating income and diluted net operating earnings per share to GAAP net income and GAAP diluted earnings per share is presented in the following table.

**Reconciliation of GAAP Net Income to Net Operating Income (non-GAAP)**

<i>(in thousands, except per share)</i>	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>GAAP Net Income</b>	<b>\$ 1,875</b>	<b>\$ 1,447</b>
Loss on sale and call of securities <sup>1</sup>		4
Amortization of intangibles <sup>1</sup>	79	141
<b>Net operating income <sup>2</sup></b>	<b>\$ 1,954</b>	<b>\$ 1,592</b>
<b>GAAP diluted earnings per share</b>	<b>\$ 0.46</b>	<b>\$ 0.51</b>
Loss on sale and call of securities <sup>1</sup>		
Amortization of intangibles <sup>1</sup>	0.02	0.05
<b>Diluted net operating earnings per share <sup>2</sup></b>	<b>\$ 0.48</b>	<b>\$ 0.56</b>

1 Tax effected

2 Non-GAAP measure

**Other Results of Operations**

Net interest income was \$6.3 million during the first quarter of 2011, up 3.6% compared with the first quarter of 2010 and 3.5% from the fourth quarter of 2010. Growth in net interest-earning assets drove the increase from fourth quarter

2010 and also offset the net interest margin contraction from first quarter 2010. Core loans, which are defined as total loans and leases less direct financing leases, were \$519.2 million at March 31, 2011, an increase of 9.8% from \$472.9 million at March 31, 2010, and up 1.3% (5.2% annualized) from \$512.5 million at December 31, 2010. The annualized growth rate in the fourth quarter of 2010 for the core loan portfolio was 21.9%. The large



**Table of Contents**

amount of loans closed in the fourth quarter of 2010 left the loan pipeline relatively lighter to start 2011. The commercial real estate portfolio experienced the strongest growth of the different portfolio segments with growth of \$5.8 million or 2.0% (8.0% annualized) in the first quarter of 2011.

Net interest margin remained relatively strong at 4.05% for the first quarter of 2011, compared with 4.00% in the 2010 fourth quarter and 4.28% in the 2010 first quarter. The 5 basis point increase in net interest margin in the first quarter of 2011 compared to the fourth quarter of 2010 was a result of larger than normal prepayment fees of \$0.2 million, which are recorded in interest income and were a result of large commercial loan payoffs and re-financings. Adjusting for the increase in prepayments the net interest margin would have compressed by 6 basis points to 3.94% for the first quarter 2011 compared with fourth quarter 2010. Although the net interest margin compression is slowing in relation to the last several quarters compression rate, it is consistent with the quarter over quarter net interest margin trend. When comparing first quarter 2011 net interest margin to first quarter 2010, the largest factor in the compression of the net interest margin is the declining interest rate environment. As the low interest rate cycle matures, the Company's loan and investment portfolios continue to re-price into lower yields as evidenced by a decline in yield on interest-earning assets of 30 basis points from the first quarter of 2010. The Company benefited from re-pricing its interest-bearing liabilities much earlier in the interest rate cycle and these rates have fallen less than its interest-earning assets in 2011. The cost of interest-bearing liabilities for the Company declined only 4 basis points in the first-quarter 2011 from the first-quarter 2010.

The provision for loan and lease losses decreased to \$0.5 million in the first quarter of 2011, from \$1.4 million in the fourth quarter of 2010 and \$1.2 million in the first quarter of 2010. The primary reason for the decrease was that there was no leasing provision in the first quarter of 2011. The fourth quarter of 2010 had \$0.4 million of provision related to the leasing portfolio, while the first quarter of 2010 had \$0.8 million in leasing provision. The provision for loan losses was \$1.0 million in the fourth quarter of 2010 and \$0.4 million in the first quarter of 2010. The fourth quarter of 2010 had the relatively higher loan provision due to the increase in non-performing loans.

Non-interest income, which represented 35.5% of total revenue in the first quarter of 2011, declined 6.5%, or \$0.2 million, to \$3.5 million when compared with the first quarter of 2010. The decrease was attributable to a reduction in service charges and insurance agency revenue. Service charges on deposits decreased \$125 thousand, or 24.5%, compared with the first quarter 2010, primarily due to new Regulation E rules pertaining to overdraft fees. Insurance agency revenue of \$2.1 million was down \$157 thousand, or 7.0%, when compared with the 2010 first quarter as the soft insurance market and macro-economic conditions continue to put downward pressure on personal and commercial property and casualty insurance commissions.

Total non-interest expense was \$6.6 million in the first quarter of 2011, an increase of \$0.1 million, or 2.4%, from \$6.5 million in the first quarter of 2010. The largest component of the increase was salaries and employee benefits, which increased \$0.3 million, or 8.2%, to \$3.9 million in the first quarter of 2011 compared with the prior-year first quarter. This rise reflected merit increases awarded for 2010 performance and increased staff, including commercial loan officers and other business-generating positions. This was partially off-set by a decline in other expenses, primarily related to a reduced amortization expense with respect to intangible assets acquired in the purchase of Suchak Data Systems, Inc., which were fully amortized at the end of 2010.

As a result of the increase in non-interest expense and the decrease in non-interest income, the efficiency ratio, excluding goodwill impairment and intangible amortization, increased to 66.36% for the first quarter of 2011, from 63.56% in the first quarter of 2010.

Income tax expense for the quarter ended March 31, 2011 was \$0.8 million, an effective tax rate of 29.6%, compared with an effective tax rate of 31.6% in the first quarter of 2010. The higher effective tax rate for the first quarter 2010 reflected tax adjustments related to the wind down of the leasing portfolio requiring an increase in the state income tax valuation allowance.

**CAPITAL**

The Company consistently maintains regulatory capital ratios measurably above the federal well capitalized standard, including a Tier 1 leverage ratio of 9.89% at March 31, 2011 and 9.93% at December 31, 2010. Book value per share of the Company's common stock was \$15.71 at March 31, 2011, compared with \$15.45 at December 31, 2010. Tangible book value per share at March 31, 2011 was \$13.48, compared with \$13.18 at December 31,



**Table of Contents**

2010. The increase in both book value and tangible book value per share is a result of the increase in the Company's earnings over the quarter ended December 31, 2010, somewhat offset by the dividend declared in the first quarter of 2011.

On February 15, 2011, the Board of Directors of the Company declared a semi-annual cash dividend of \$0.20 per share on the Company's outstanding common stock. The dividend was paid on April 4, 2011 to shareholders of record as of March 10, 2011. The \$0.20 dividend was equal to the previous dividend paid on October 6, 2010.

**LIQUIDITY**

The Bank utilizes cash flows from the investment portfolio and federal funds sold balances to manage the liquidity requirements related to loan demand and deposit fluctuations. The Bank also has many borrowing options. As a member of the FHLB the Bank is able to borrow funds at competitive rates. Advances of up to \$100.2 million can be drawn on the FHLB via an Overnight Line of Credit Agreement between the Bank and the FHLB. An amount equal to 25% of the Bank's total assets could be borrowed through the advance programs under certain qualifying circumstances. The Bank also has the ability to purchase up to \$14.0 million in federal funds from its correspondent banks. By placing sufficient collateral in safekeeping at the Federal Reserve Bank, the Bank could borrow at the discount window. The Bank's liquidity needs also can be met by more aggressively pursuing time deposits, or accessing the brokered time deposit market, including the Certificate of Deposit Account Registry Service ( CDARS ) network. The Company's primary source of liquidity is dividends from the Bank. Additionally, the Company has access to capital markets as a funding source, as evidenced by its recent registered public offering of common stock, described in greater detail in the Company's Annual Report on Form 10-K for the year ended December 31, 2010. Cash flows from the Bank's investment portfolio are laddered, so that securities mature at regular intervals, to provide funds from principal and interest payments at various times as liquidity needs may arise. Contractual maturities are also laddered, with consideration as to the volatility of market prices. At March 31, 2011, approximately 3.8% of the Bank's securities had contractual maturity dates of one year or less and approximately 24.0% had maturity dates of five years or less.

Management, on an ongoing basis, closely monitors the Company's liquidity position for compliance with internal policies, and believes that available sources of liquidity are adequate to meet funding needs in the normal course of business. As part of that monitoring process, management calculates the 90-day liquidity each month by analyzing the cash needs of the Bank. Included in the calculation are liquid assets and potential liabilities. Management stresses the potential liabilities calculation to ensure a strong liquidity position. Included in the calculation are assumptions of some significant deposit run-off as well as funds needed for loan closings and investment purchases. At March 31, 2011, in the Company's internal stress test, the Company had net short-term liquidity of \$77.9 million as compared with \$70.2 million at December 31, 2010.

Management does not anticipate engaging in any activities, either currently or in the long term, for which adequate funding would not be available and which would therefore result in significant pressure on liquidity. However, continued economic recession could negatively impact the Company's liquidity.

The Company believes that the Bank maintains a sufficient level of U.S. government and government agency securities and New York State municipal bonds that can be pledged as collateral for municipal deposits.

**Table of Contents****ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Additional information responsive to this Item is contained in the Liquidity section of Management's Discussion and Analysis of Financial Condition and Results of Operations, which information is incorporated herein by reference. Market risk is the risk of loss from adverse changes in market prices and/or interest rates of the Bank's financial instruments. The primary market risk the Company is exposed to is interest rate risk. The core banking activities of lending and deposit-taking expose the Bank to interest rate risk, which occurs when assets and liabilities reprice at different times and by different amounts as interest rates change. As a result, net interest income earned by the Bank is subject to the effects of changing interest rates. The Bank measures interest rate risk by calculating the variability of net interest income in future periods under various interest rate scenarios using projected balances for interest-earning assets and interest-bearing liabilities. Management's philosophy toward interest rate risk management is to limit the variability of net interest income to changes in net interest rates. The balances of financial instruments used in the projections are based on expected growth from forecasted business opportunities, anticipated prepayments of loans, and expected maturities of investment securities, loans and deposits. Management supplements the modeling technique described above with analysis of market values of the Bank's financial instruments and changes to such market values given changes in the interest rates.

The Bank's Asset-Liability Committee, which includes members of senior management, monitors the Bank's interest rate sensitivity with the aid of a model that considers the impact of ongoing lending and deposit taking activities, as well as interrelationships in the magnitude and timing of the repricing of financial instruments, including the effect of changing interest rates on expected prepayments and maturities. When deemed prudent, management has taken actions, and intends to do so in the future, to mitigate exposure to interest rate risk through the use of on- or off-balance sheet financial instruments. Possible actions include, but are not limited to, changing the pricing of loan and deposit products, and modifying the composition of interest-earning assets and interest-bearing liabilities, and other financial instruments used for interest rate risk management purposes.

The following table demonstrates the possible impact of changes in interest rates on the Bank's net interest income over a 12-month period of time:

**SENSITIVITY OF NET INTEREST INCOME TO CHANGES IN INTEREST RATES**

	<b>Calculated (decrease) increase in projected annual net interest income (in thousands)</b>	
	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Changes in interest rates		
+200 basis points	\$759	\$486
+100 basis points	867	945
-100 basis points	N/A	N/A
-200 basis points	N/A	N/A

Many assumptions were utilized by management to calculate the impact that changes in interest rates may have on the Bank's net interest income. The more significant assumptions related to the rate of prepayments of mortgage-related assets, loan and deposit volumes and pricing, and deposit maturities. The Bank assumed immediate changes in rates including 200 basis point rate changes. In the event that the 200 basis point rate changes cannot be achieved, the applicable rate changes are limited to lesser amounts such that interest rates cannot be less than zero. These assumptions are inherently uncertain and, as a result, the Bank cannot precisely predict the impact of changes in interest rates on net interest income. Actual results may differ significantly due to the timing, magnitude, and frequency of interest rate changes in market conditions and interest rate differentials (spreads) between maturity/repricing categories, as well as any actions such as those previously described, which management may take to counter such changes. In light of the uncertainties and assumptions associated with the process, the amounts



**Table of Contents**

presented in the table and changes in such amounts are not considered significant to the Bank's projected net interest income.

**ITEM 4 CONTROLS AND PROCEDURES**

**DISCLOSURE CONTROLS AND PROCEDURES**

The Company's management, with the participation of the Company's principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of March 31, 2011 (the end of the period covered by this Report). Based on that evaluation, the Company's principal executive and principal financial officers concluded that as of March 31, 2011 the Company's disclosure controls and procedures were effective.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

No changes in the Company's internal control over financial reporting were identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 under the Exchange Act that occurred during the fiscal quarter ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 6 EXHIBITS**

The information called for by this item is incorporated herein by reference to the Exhibit Index included immediately following the signature page to this Quarterly Report on Form 10-Q.

**Table of Contents**

**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.

Evans Bancorp, Inc.

DATE May 6, 2011

/s/ David J. Nasca  
David J. Nasca  
President and CEO  
(Principal Executive Officer)

DATE May 6, 2011

/s/ Gary A. Kajtoch  
Gary A. Kajtoch  
Treasurer  
(Principal Financial Officer)  
43

---

**Table of Contents**

**EXHIBIT INDEX**

Exhibit No.	Name	Page No.
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	45
31.2	Certification of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	46
32.1	Certification of Principal Executive Officer pursuant to 18 USC Section 1350 Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	47
32.2	Certification of Principal Financial Officer pursuant to 18 USC Section 1350 Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	48