

EVANS BANCORP INC  
Form 10-Q  
August 03, 2012  
[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 June 30, 2012

**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)

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**New York**  
(State or other jurisdiction of

**16-1332767**  
(I.R.S. Employer

incorporation or organization)

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  (Do not check if smaller reporting company)

Smaller reporting company

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

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

Common Stock, \$.50 par value: 4,153,332 shares as of July 31, 2012

**Table of Contents**

INDEX

EVANS BANCORP, INC. AND SUBSIDIARIES

|  | <b>PAGE</b> |
|--|-------------|
| PART I. FINANCIAL INFORMATION  |             |
| <u>Item 1. Financial Statements</u>  |             |
| <u>Unaudited Consolidated Balance Sheets June 30, 2012 and December 31, 2011</u>                           | 1           |
| <u>Unaudited Consolidated Statements of Income Three months ended June 30, 2012 and 2011</u>               | 2           |
| <u>Unaudited Consolidated Statements of Income Six months ended June 30, 2012 and 2011</u>                 | 3           |
| <u>Unaudited Statements of Consolidated Comprehensive Income Three months ended June 30, 2012 and 2011</u> | 4           |
| <u>Unaudited Statements of Consolidated Comprehensive Income Six months ended June 30, 2012 and 2011</u>   | 5           |
| <u>Unaudited Consolidated Statements of Stockholders Equity Six months ended June 30, 2012 and 2011</u>    | 6           |
| <u>Unaudited Consolidated Statements of Cash Flows Six months ended June 30, 2012 and 2011</u>             | 7           |
| <u>Notes to Unaudited Consolidated Financial Statements</u>  | 9           |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>       | 39          |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>                                  | 50          |
| <u>Item 4. Controls and Procedures</u>   | 51          |
| PART II. OTHER INFORMATION   |             |
| <u>Item 6. Exhibits</u>  | 51          |
| <u>SIGNATURES</u>  | 52          |

**Table of Contents**

## PART I FINANCIAL INFORMATION

## ITEM I FINANCIAL STATEMENTS

## EVANS BANCORP, INC. AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED BALANCE SHEETS

JUNE 30, 2012 AND DECEMBER 31, 2011

(in thousands, except share and per share amounts)

|   | June 30,<br>2012  | December 31,<br>2011 |
|---|-------------------|----------------------|
| <b>ASSETS</b>   |                   |                      |
| Cash and due from banks   | \$ 12,540         | \$ 11,486            |
| Interest-bearing deposits at banks  | 31,445            | 3,192                |
| Securities:   |                   |                      |
| Available for sale, at fair value (cost: \$89,125 at June 30, 2012; \$95,848 at December 31, 2011)                          | 93,094            | 99,981               |
| Held to maturity, at amortized cost (fair value: \$3,730 at June 30, 2012; \$3,811 at December 31, 2011)                    | 3,708             | 3,802                |
| Federal Home Loan Bank common stock, at amortized cost  | 1,804             | 1,830                |
| Federal Reserve Bank common stock, at amortized cost  | 1,434             | 1,425                |
| Loans and leases, net of allowance for loan and lease losses of \$10,658 at June 30, 2012 and \$11,495 at December 31, 2011 | 587,265           | 571,910              |
| Properties and equipment, net of depreciation of \$13,687 at June 30, 2012 and \$13,145 at December 31, 2011                | 10,497            | 10,477               |
| Goodwill  | 8,101             | 8,101                |
| Intangible assets   | 468               | 678                  |
| Bank-owned life insurance   | 15,095            | 14,843               |
| Other assets  | 12,671            | 13,177               |
| <b>TOTAL ASSETS</b>   | <b>\$ 778,122</b> | <b>\$ 740,902</b>    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                   |                      |
| <b>LIABILITIES</b>  |                   |                      |
| Deposits:   |                   |                      |
| Demand  | \$ 116,231        | \$ 118,037           |
| NOW   | 63,535            | 50,761               |
| Regular savings   | 342,992           | 313,777              |
| Muni-vest   | 22,883            | 20,161               |
| Time  | 108,279           | 113,467              |
| Total deposits  | 653,920           | 616,203              |
| Securities sold under agreement to repurchase   | 9,855             | 9,010                |
| Other borrowings  | 19,000            | 22,000               |
| Other liabilities   | 11,736            | 13,371               |
| Junior subordinated debentures  | 11,330            | 11,330               |
| Total liabilities   | 705,841           | 671,914              |

## CONTINGENT LIABILITIES AND COMMITMENTS

## STOCKHOLDERS EQUITY:

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Common stock, \$.50 par value, 10,000,000 shares authorized; 4,153,332 and 4,125,272 shares issued at June 30, 2012 and December 31, 2011, respectively, and 4,153,332 and 4,124,892 shares outstanding, at June 30, 2012 and December 31, 2011, respectively

|   |                   |                   |
|---|-------------------|-------------------|
|   | 2,077             | 2,063             |
| Capital surplus                                   | 41,611            | 41,275            |
| Retained earnings                                 | 28,269            | 25,304            |
| Accumulated other comprehensive gain, net of tax  | 324               | 346               |
| <br>Total stockholders' equity                    | <br>72,281        | <br>68,988        |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 778,122</b> | <b>\$ 740,902</b> |

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

## PART I FINANCIAL INFORMATION

## ITEM I FINANCIAL STATEMENTS

## EVANS BANCORP, INC. AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

## THREE MONTHS ENDED JUNE 30, 2012 AND 2011

(in thousands, except share and per share amounts)

|  | Three Months Ended June 30, |              |
|--|-----------------------------|--------------|
|  | 2012                        | 2011         |
| <b>INTEREST INCOME</b>   |                             |              |
| Loans and leases   | \$ 7,521                    | \$ 7,081     |
| Interest bearing deposits at banks                                       | 15                          | 7            |
| Securities:  |                             |              |
| Taxable  | 457                         | 538          |
| Non-taxable  | 296                         | 389          |
| <b>Total interest income</b>   | <b>8,289</b>                | <b>8,015</b> |
| <b>INTEREST EXPENSE</b>  |                             |              |
| Deposits   | 1,146                       | 1,461        |
| Other borrowings   | 177                         | 185          |
| Junior subordinated debentures   | 85                          | 82           |
| <b>Total interest expense</b>  | <b>1,408</b>                | <b>1,728</b> |
| <b>NET INTEREST INCOME</b>   | <b>6,881</b>                | <b>6,287</b> |
| <b>PROVISION FOR LOAN AND LEASE LOSSES</b>                               | <b>301</b>                  | <b>1,009</b> |
| <b>NET INTEREST INCOME AFTER<br/>PROVISION FOR LOAN AND LEASE LOSSES</b> | <b>6,580</b>                | <b>5,278</b> |
| <b>NON-INTEREST INCOME</b>   |                             |              |
| Bank charges   | 437                         | 416          |
| Insurance service and fees   | 1,643                       | 1,601        |
| Data center income   | 119                         | 192          |
| Gain on loans sold   | 75                          | 20           |
| Bank-owned life insurance  | 134                         | 110          |
| Other  | 630                         | 586          |
| <b>Total non-interest income</b>   | <b>3,038</b>                | <b>2,925</b> |
| <b>NON-INTEREST EXPENSE</b>  |                             |              |
| Salaries and employee benefits   | 4,229                       | 3,912        |
| Occupancy  | 645                         | 816          |
| Repairs and maintenance  | 177                         | 155          |
| Advertising and public relations   | 336                         | 247          |
| Professional services  | 567                         | 407          |
| Technology and communications  | 269                         | 220          |
| Amortization of intangibles  | 106                         | 126          |
| FDIC insurance   | 139                         | 135          |
| Other  | 855                         | 744          |
| <b>Total non-interest expense</b>  | <b>7,323</b>                | <b>6,762</b> |

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|   |           |           |
|---|-----------|-----------|
| INCOME BEFORE INCOME TAXES                            | 2,295     | 1,441     |
| INCOME TAX PROVISION                                  | 800       | 469       |
| NET INCOME  | \$ 1,495  | \$ 972    |
| Net income per common share-basic                     | \$ 0.36   | \$ 0.24   |
| Net income per common share-diluted                   | \$ 0.36   | \$ 0.24   |
| Cash dividends per common share                       | \$ 0.00   | \$ 0.00   |
| Weighted average number of common shares outstanding  | 4,139,805 | 4,100,201 |
| Weighted average number of diluted shares outstanding | 4,156,868 | 4,106,371 |

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

## PART I FINANCIAL INFORMATION

## ITEM I FINANCIAL STATEMENTS

## EVANS BANCORP, INC. AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED STATEMENTS OF INCOME

## SIX MONTHS ENDED JUNE 30, 2012 AND 2011

(in thousands, except share and per share amounts)

|  | Six Months Ended June 30, |               |
|--|---------------------------|---------------|
|  | 2012                      | 2011          |
| <b>INTEREST INCOME</b>   |                           |               |
| Loans and leases   | \$ 15,029                 | \$ 14,233     |
| Interest bearing deposits at banks                                       | 24                        | 11            |
| Securities:  |                           |               |
| Taxable  | 1,002                     | 1,024         |
| Non-taxable  | 603                       | 760           |
| <b>Total interest income</b>   | <b>16,658</b>             | <b>16,028</b> |
| <b>INTEREST EXPENSE</b>  |                           |               |
| Deposits   | 2,388                     | 2,882         |
| Other borrowings   | 364                       | 400           |
| Junior subordinated debentures   | 173                       | 163           |
| <b>Total interest expense</b>  | <b>2,925</b>              | <b>3,445</b>  |
| <b>NET INTEREST INCOME</b>   | <b>13,733</b>             | <b>12,583</b> |
| <b>PROVISION FOR LOAN AND LEASE LOSSES</b>                               | <b>52</b>                 | <b>1,497</b>  |
| <b>NET INTEREST INCOME AFTER<br/>PROVISION FOR LOAN AND LEASE LOSSES</b> |                           |               |
|  | <b>13,681</b>             | <b>11,086</b> |
| <b>NON-INTEREST INCOME</b>   |                           |               |
| Bank charges   | 873                       | 802           |
| Insurance service and fees   | 3,589                     | 3,690         |
| Data center income   | 244                       | 431           |
| Gain on loans sold   | 128                       | 72            |
| Bank-owned life insurance  | 252                       | 213           |
| Other  | 1,241                     | 1,178         |
| <b>Total non-interest income</b>   | <b>6,327</b>              | <b>6,386</b>  |
| <b>NON-INTEREST EXPENSE</b>  |                           |               |
| Salaries and employee benefits   | 8,443                     | 7,816         |
| Occupancy  | 1,330                     | 1,593         |
| Repairs and maintenance  | 346                       | 314           |
| Advertising and public relations   | 481                       | 377           |
| Professional services  | 1,106                     | 809           |
| Technology and communications  | 517                       | 454           |
| Amortization of intangibles  | 210                       | 256           |
| FDIC Insurance   | 274                       | 364           |
| Other  | 1,525                     | 1,383         |
| <b>Total non-interest expense</b>  | <b>14,232</b>             | <b>13,366</b> |



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|   |           |           |
|---|-----------|-----------|
| INCOME BEFORE INCOME TAXES                            | 5,776     | 4,106     |
| INCOME TAX PROVISION                                  | 1,902     | 1,259     |
| NET INCOME  | \$ 3,874  | \$ 2,847  |
| Net income per common share-basic                     | \$ 0.94   | \$ 0.70   |
| Net income per common share-diluted                   | \$ 0.94   | \$ 0.69   |
| Cash dividends per common share                       | \$ 0.22   | \$ 0.20   |
| Weighted average number of common shares outstanding  | 4,133,230 | 4,092,896 |
| Weighted average number of diluted shares outstanding | 4,142,209 | 4,100,635 |

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

PART I FINANCIAL INFORMATION

ITEM I FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

THREE MONTHS ENDED JUNE 30, 2012 AND 2011

(in thousands, except share and per share amounts)

|  | <b>Three Months Ended June 30,</b> |             |
|--|------------------------------------|-------------|
|  | <b>2012</b>                        | <b>2011</b> |
| NET INCOME                                       | \$ 1,495                           | \$ 972      |
| OTHER COMPREHENSIVE INCOME, NET OF TAX:          |                                    |             |
| Unrealized gain on available-for-sale securities | 14                                 | 741         |
| Defined benefit pension plans:                   |                                    |             |
| Amortization of prior service cost               | 13                                 | 13          |
| Amortization of actuarial loss                   | 26                                 | 6           |
| Total  | 39                                 | 19          |
| OTHER COMPREHENSIVE INCOME, NET OF TAX           | 53                                 | 760         |
| COMPREHENSIVE INCOME                             | 1,548                              | 1,732       |

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

PART I FINANCIAL INFORMATION

ITEM I FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

UNAUDITED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

SIX MONTHS ENDED JUNE 30, 2012 AND 2011

(in thousands, except share and per share amounts)

|   | <b>Six Months Ended June 30,</b> |             |
|---|----------------------------------|-------------|
|   | <b>2012</b>                      | <b>2011</b> |
| NET INCOME  | \$ 3,874                         | \$ 2,847    |
| OTHER COMPREHENSIVE (LOSS) INCOME, NET OF TAX:          |                                  |             |
| Unrealized (loss) gain on available-for-sale securities | (101)                            | 865         |
| Defined benefit pension plans:                          |                                  |             |
| Amortization of prior service cost                      | 27                               | 27          |
| Amortization of actuarial loss                          | 52                               | 12          |
| Total   | 79                               | 39          |
| OTHER COMPREHENSIVE (LOSS) INCOME, NET OF TAX           | (22)                             | 904         |
| COMPREHENSIVE INCOME                                    | 3,852                            | 3,751       |

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

## PART 1 FINANCIAL INFORMATION

## ITEM 1 FINANCIAL STATEMENTS

## EVANS BANCORP, INC. AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

SIX MONTHS ENDED JUNE 30, 2012 AND 2011

(in thousands, except share and per share amounts)

|  | Common<br>Stock | Capital<br>Surplus | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>(Loss)<br>Income | Total     |
|--|-----------------|--------------------|----------------------|---|-----------|
| <b>Balance, December 31, 2010</b>                | \$ 2,041        | \$ 40,660          | \$ 20,836            | (\$473)   | \$ 63,064 |
| Net Income                                       |                 |                    | 2,847                |   | 2,847     |
| Other comprehensive income                       |                 |                    |                      | 904   | 904       |
| Cash dividends (\$0.20 per common share)         |                 |                    | (816)                |   | (816)     |
| Stock options expense                            |                 | 127                |                      |   | 127       |
| Excess tax benefit from stock-based compensation |                 | 9                  |                      |   | 9         |
| Issued 12,260 restricted shares                  | 6               | (6)                |                      |   |           |
| Issued 7,784 shares under ESPP                   | 4               | 87                 |                      |   | 91        |
| Issued 6,172 shares in DRIP                      | 3               | 84                 |                      |   | 87        |
| <b>Balance, June 30, 2011</b>                    | \$ 2,054        | \$ 40,961          | \$ 22,867            | \$ 431  | \$ 66,313 |
| <b>Balance, December 31, 2011</b>                | \$ 2,063        | \$ 41,275          | \$ 25,304            | \$ 346  | \$ 68,988 |
| Net Income                                       |                 |                    | 3,874                |   | 3,874     |
| Other comprehensive loss                         |                 |                    |                      | (22)  | (22)      |
| Cash dividends (\$0.22 per common share)         |                 |                    | (909)                |   | (909)     |
| Stock options expense                            |                 | 151                |                      |   | 151       |
| Issued 11,493 restricted shares                  | 6               | (6)                |                      |   |           |
| Issued 10,267 shares under ESPP                  | 5               | 99                 |                      |   | 104       |
| Issued 6,680 shares in DRIP                      | 3               | 92                 |                      |   | 95        |
| <b>Balance, June 30, 2012</b>                    | \$ 2,077        | \$ 41,611          | \$ 28,269            | \$ 324  | \$ 72,281 |

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

## PART I FINANCIAL INFORMATION

## ITEM I FINANCIAL STATEMENTS

## EVANS BANCORP, INC. AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

## SIX MONTHS ENDED JUNE 30, 2012 AND 2011

(in thousands)

|   | Six Months Ended |           |
|---|------------------|-----------|
|   | June 30,         |           |
|   | 2012             | 2011      |
| <b>OPERATING ACTIVITIES:</b>                  |                  |           |
| Interest received                             | \$ 16,526        | \$ 15,833 |
| Fees received                                 | 5,802            | 6,327     |
| Interest paid                                 | (2,968)          | (3,493)   |
| Cash paid to employees and vendors            | (13,137)         | (12,007)  |
| Cash contributed to pension plan              | (310)            |           |
| Income taxes paid                             | (2,274)          | (1,712)   |
| Proceeds from sale of loans held for resale   | 11,268           | 13,116    |
| Originations of loans held for resale         | (8,575)          | (15,590)  |
| Net cash provided by operating activities     | 6,332            | 2,474     |
| <b>INVESTING ACTIVITIES:</b>                  |                  |           |
| Available for sales securities:               |                  |           |
| Purchases                                     | (23,936)         | (10,290)  |
| Proceeds from maturities, calls, and payments | 30,741           | 7,470     |
| Held to maturity securities:                  |                  |           |
| Purchases                                     | (638)            | (435)     |
| Proceeds from maturities, calls, and payments | 732              | 91        |
| Additions to properties and equipment         | (563)            | (176)     |
| Net increase in loans                         | (18,214)         | (13,609)  |
| Net cash used in investing activities         | (11,878)         | (16,949)  |
| <b>FINANCING ACTIVITIES:</b>                  |                  |           |
| Repayments of borrowings                      | (2,155)          | (13,304)  |
| Net increase in deposits                      | 37,718           | 42,310    |
| Dividends paid                                | (909)            | (816)     |
| Issuance of common stock                      | 199              | 178       |
| Net cash provided by financing activities     | 34,853           | 28,368    |
| Net increase in cash and equivalents          | 29,307           | 13,893    |
| <b>CASH AND CASH EQUIVALENTS:</b>             |                  |           |
| Beginning of period                           | 14,678           | 13,722    |
| End of period                                 | \$ 43,985        | \$ 27,615 |



**Table of Contents**

|   | Six Months Ended |                 |
|---|------------------|-----------------|
| (in thousands)  | June 30,         |                 |
|   | 2012             | 2011            |
| <b>RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:</b> |                  |                 |
| Net income  | \$ 3,874         | \$ 2,847        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                 |
| Depreciation and amortization   | 636              | 662             |
| Deferred tax expense  | 398              | 109             |
| Provision for loan and lease losses   | 52               | 1,497           |
| Premium on loans sold   | (128)            | (72)            |
| Stock options expense   | 151              | 127             |
| Proceeds from sale of loans held for resale                                       | 11,268           | 13,116          |
| Originations of loans held for resale   | (8,575)          | (15,590)        |
| Cash contributed to pension plan  | (310)            |                 |
| Changes in assets and liabilities affecting cash flow:                            |                  |                 |
| Other assets  | 213              | 536             |
| Other liabilities   | (1,247)          | (758)           |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>\$ 6,332</b>  | <b>\$ 2,474</b> |

*See Notes to Unaudited Consolidated Financial Statements*

**Table of Contents**

PART 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE AND SIX MONTHS ENDED JUNE 30, 2012 AND 2011

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The 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 2011 unaudited consolidated financial statements to conform to the presentation used in 2012.

The results of operations for the three and six month periods ended June 30, 2012 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, 2011. 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 June 30, 2012 and December 31, 2011 were as follows:



**Table of Contents**

|  | <b>June 30, 2012</b><br>(in thousands)<br><b>Unrealized</b> |                 |                |                       |  |
|--|---|-----------------|----------------|-----------------------|--|
|  | <b>Amortized<br/>Cost</b>                                   | <b>Gains</b>    | <b>Losses</b>  | <b>Fair<br/>Value</b> |  |
| <b>Available for Sale:</b>                               |   |                 |                |                       |  |
| Debt securities:   |   |                 |                |                       |  |
| U.S. government agencies                                 | \$ 24,061   | \$ 1,246        | \$             | \$ 25,307             |  |
| States and political subdivisions                        | 30,407  | 1,495           | (43)           | 31,859                |  |
| <b>Total debt securities</b>                             | <b>\$ 54,468</b>  | <b>\$ 2,741</b> | <b>(\$ 43)</b> | <b>\$ 57,166</b>      |  |
| Mortgage-backed securities:                              |   |                 |                |                       |  |
| FNMA   | \$ 18,210   | \$ 807          | \$             | \$ 19,017             |  |
| FHLMC  | 5,621   | 222             |                | 5,843                 |  |
| GNMA   | 8,885   | 223             | (10)           | 9,098                 |  |
| CMO  | 1,941   | 29              |                | 1,970                 |  |
| <b>Total mortgage-backed securities</b>                  | <b>\$ 34,657</b>  | <b>\$ 1,281</b> | <b>(\$ 10)</b> | <b>\$ 35,928</b>      |  |
| <b>Total securities designated as available for sale</b> | <b>\$ 89,125</b>  | <b>\$ 4,022</b> | <b>(\$ 53)</b> | <b>\$ 93,094</b>      |  |
| <b>Held to Maturity:</b>                                 |   |                 |                |                       |  |
| Debt securities  |   |                 |                |                       |  |
| States and political subdivisions                        | 3,708   | 31              | (9)            | 3,730                 |  |
| <b>Total securities designated as held to maturity</b>   | <b>\$ 3,708</b>   | <b>\$ 31</b>    | <b>(\$ 9)</b>  | <b>\$ 3,730</b>       |  |
| <b>Total securities</b>                                  | <b>\$ 92,833</b>  | <b>\$ 4,053</b> | <b>(\$ 62)</b> | <b>\$ 96,824</b>      |  |

|  | <b>December 31, 2011</b><br>(in thousands)<br><b>Unrealized</b> |                 |               |                       |  |
|--|---|-----------------|---------------|-----------------------|--|
|  | <b>Amortized<br/>Cost</b>                                       | <b>Gains</b>    | <b>Losses</b> | <b>Fair<br/>Value</b> |  |
| <b>Available for Sale:</b>                               |   |                 |               |                       |  |
| Debt securities:   |   |                 |               |                       |  |
| U.S. Treasury and other U.S. government agencies         | \$ 29,002   | \$ 1,250        | \$            | \$ 30,252             |  |
| States and political subdivisions                        | 30,632  | 1,698           | (4)           | 32,326                |  |
| <b>Total debt securities</b>                             | <b>\$ 59,634</b>  | <b>\$ 2,948</b> | <b>(\$ 4)</b> | <b>\$ 62,578</b>      |  |
| Mortgage-backed securities:                              |   |                 |               |                       |  |
| FNMA   | \$ 20,071   | \$ 647          |               | \$ 20,718             |  |
| FHLMC  | 8,052   | 269             |               | 8,321                 |  |
| GNMA   | 5,895   | 248             |               | 6,143                 |  |
| CMO  | 2,196   | 25              |               | 2,221                 |  |
| <b>Total mortgage-backed securities</b>                  | <b>\$ 36,214</b>  | <b>\$ 1,189</b> |               | <b>\$ 37,403</b>      |  |
| <b>Total securities designated as available for sale</b> | <b>\$ 95,848</b>  | <b>\$ 4,137</b> | <b>(\$ 4)</b> | <b>\$ 99,981</b>      |  |
| <b>Held to Maturity:</b>                                 |   |                 |               |                       |  |
| Debt securities  |   |                 |               |                       |  |
| States and political subdivisions                        | 3,802   | 24              | (15)          | 3,811                 |  |

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|   |    |        |    |       |     |     |    |         |
|---|----|--------|----|-------|-----|-----|----|---------|
| Total securities designated as held to maturity | \$ | 3,802  | \$ | 24    | (\$ | 15) | \$ | 3,811   |
| Total securities                                | \$ | 99,650 | \$ | 4,161 | (\$ | 19) | \$ | 103,792 |

Available for sale securities with a total fair value of \$75.2 million and \$76.7 million at June 30, 2012 and December 31, 2011, 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 \$19.0 million and \$22.0 million in borrowed funds with FHLBNY at June 30, 2012 and December 31, 2011, 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 in FHLBNY stock as of June 30, 2012 and December 31, 2011, respectively, at amortized cost.

The scheduled maturities of debt and mortgage-backed securities at June 30, 2012 and December 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.

|   | June 30, 2012     |                         | December 31, 2011 |                         |
|---|-------------------|-------------------------|-------------------|-------------------------|
|   | Amortized<br>cost | Estimated<br>fair value | Amortized<br>cost | Estimated<br>fair value |
|   | (in thousands)    |                         | (in thousands)    |                         |
| <b>Debt securities available for sale:</b>    |                   |                         |                   |                         |
| Due in one year or less                       | \$ 2,121          | \$ 2,148                | \$ 2,426          | \$ 2,453                |
| Due after one year through five years         | 16,299            | 17,013                  | 18,454            | 19,231                  |
| Due after five years through ten years        | 26,644            | 27,774                  | 24,995            | 26,238                  |
| Due after ten years                           | 9,404             | 10,231                  | 13,759            | 14,656                  |
|   | 54,468            | 57,166                  | 59,634            | 62,578                  |
| Mortgage-backed securities available for sale | 34,657            | 35,928                  | 36,214            | 37,403                  |
| Total available for sale securities           | \$ 89,125         | \$ 93,094               | \$ 95,848         | \$ 99,981               |
| <b>Debt securities held to maturity:</b>      |                   |                         |                   |                         |
| Due in one year or less                       | \$ 2,581          | \$ 2,573                | \$ 2,656          | \$ 2,644                |
| Due after one year through five years         | 534               | 547                     | 518               | 529                     |
| Due after five years through ten years        | 35                | 37                      | 40                | 42                      |
| Due after ten years                           | 558               | 573                     | 588               | 596                     |
| Total held to maturity securities             | \$ 3,708          | \$ 3,730                | \$ 3,802          | \$ 3,811                |

Information regarding unrealized losses within the Company's available for sale securities at June 30, 2012 and December 31, 2011, 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 |                   | June 30, 2012<br>12 months or longer |                   | Total           |                   |
|--|---------------------|-------------------|--------------------------------------|-------------------|-----------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value                           | Unrealized Losses | Fair Value      | Unrealized Losses |
| (in thousands)                               |                     |                   |                                      |                   |                 |                   |
| <b>Available for Sale:</b>                   |                     |                   |                                      |                   |                 |                   |
| <b>Debt securities:</b>                      |                     |                   |                                      |                   |                 |                   |
| U.S. government agencies                     | \$                  | \$                | \$                                   | \$                | \$              | \$                |
| States and political subdivisions            | 4,326               | (39)              | 303                                  | (4)               | 4,629           | (43)              |
| <b>Total debt securities</b>                 | <b>\$4,326</b>      | <b>(\$39)</b>     | <b>\$303</b>                         | <b>(\$4)</b>      | <b>\$ 4,629</b> | <b>(\$43)</b>     |
| <b>Mortgage-backed securities:</b>           |                     |                   |                                      |                   |                 |                   |
| FNMA   | \$                  | \$                | \$                                   | \$                | \$              | \$                |
| FHLMC  |                     |                   |                                      |                   |                 |                   |
| GNMA   | 2,160               | (10)              |                                      |                   | 2,160           | (10)              |
| CMO S  |                     |                   |                                      |                   |                 |                   |
| <b>Total mortgage-backed securities</b>      | <b>\$ 2,160</b>     | <b>(\$10)</b>     | <b>\$</b>                            | <b>\$</b>         | <b>\$ 2,160</b> | <b>(\$10)</b>     |
| <b>Held To Maturity:</b>                     |                     |                   |                                      |                   |                 |                   |
| <b>Debt securities:</b>                      |                     |                   |                                      |                   |                 |                   |
| States and political subdivisions            | \$ 2,174            | (\$9)             | \$ 0                                 | \$ 0              | \$ 2,174        | (\$9)             |
| <b>Total temporarily impaired securities</b> | <b>\$ 8,660</b>     | <b>(\$58)</b>     | <b>\$ 303</b>                        | <b>(\$4)</b>      | <b>\$ 8,963</b> | <b>(\$62)</b>     |

|  | Less than 12 months |                   | December 31, 2011<br>12 months or longer |                   | Total           |                   |
|--|---------------------|-------------------|--|-------------------|-----------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value                               | Unrealized Losses | Fair Value      | Unrealized Losses |
| (in thousands)                                   |                     |                   |  |                   |                 |                   |
| <b>Available for Sale:</b>                       |                     |                   |  |                   |                 |                   |
| <b>Debt securities:</b>                          |                     |                   |  |                   |                 |                   |
| U.S. Treasury and other U.S. government agencies | \$                  | \$                | \$                                       | \$                | \$              | \$                |
| States and political subdivisions                | 401                 | (1)               | 304                                      | (3)               | 705             | (4)               |
| <b>Total debt securities</b>                     | <b>\$ 401</b>       | <b>(\$1)</b>      | <b>\$304</b>                             | <b>(\$3)</b>      | <b>\$ 705</b>   | <b>(\$4)</b>      |
| <b>Mortgage-backed securities:</b>               |                     |                   |  |                   |                 |                   |
| FNMA   | \$                  | \$                | \$                                       | \$                | \$              | \$                |
| FHLMC  |                     |                   |  |                   |                 |                   |
| GNMA   |                     |                   |  |                   |                 |                   |
| CMO S  |                     |                   |  |                   |                 |                   |
| <b>Total mortgage-backed securities</b>          | <b>\$</b>           | <b>\$</b>         | <b>\$</b>                                | <b>\$</b>         | <b>\$</b>       | <b>\$</b>         |
| <b>Held To Maturity:</b>                         |                     |                   |  |                   |                 |                   |
| <b>Debt securities:</b>                          |                     |                   |  |                   |                 |                   |
| States and political subdivisions                | \$ 2,239            | (\$12)            | \$ 1,006                                 | (\$3)             | \$ 3,245        | (\$15)            |
| <b>Total temporarily impaired securities</b>     | <b>\$ 2,640</b>     | <b>(\$13)</b>     | <b>\$ 1,310</b>                          | <b>(\$6)</b>      | <b>\$ 3,950</b> | <b>(\$19)</b>     |

In regard to municipal securities, the Company's general investment policy is that in-state securities must be rated at least Moody's Baa (or equivalent) at the time of purchase. The Company reviews the ratings report and municipality financial statements and prepares a pre-purchase analysis report before the purchase of any municipal securities. Out-of-state issues must be rated by Moody's at least Aa (or equivalent) at the time of purchase. The Company did not own any out-of-state municipal bonds at June 30, 2012 or December 31, 2011. Bonds rated below A are reviewed periodically to ensure their continued credit worthiness. While purchase of non-rated municipal securities is permitted under the

Company's investment policy, such purchases are limited to bonds issued by

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**Table of Contents**

municipalities in the Company's general market area. Those municipalities are typically customers of the Bank whose financial situation is familiar to management. The financial statements of the issuers of non-rated securities are reviewed by the Bank and a credit file of the issuers is kept on each non-rated municipal security with relevant financial information.

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

Management has assessed the securities available for sale in an unrealized loss position at June 30, 2012 and December 31, 2011 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 2012 or 2011, with the gross unrealized losses at an immaterial level, amounting to less than 0.1% of the total fair value of the securities portfolio at June 30, 2012 and December 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.

**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



**Table of Contents**

instruments which are measured at fair value on a recurring basis at June 30, 2012 and December 31, 2011:

|  | Level 1 | Level 2   | Level 3 | Fair Value |
|--|---------|-----------|---------|------------|
| <b>June 30, 2012</b>                             |         |           |         |            |
| Securities available-for-sale:                   |         |           |         |            |
| U.S. government agencies                         | \$      | \$ 25,307 | \$      | \$ 25,307  |
| States and political subdivisions                |         | 31,859    |         | 31,859     |
| Mortgage-backed securities                       |         | 35,928    |         | 35,928     |
| Mortgage servicing rights                        |         |           | 448     | 448        |
| <b>December 31, 2011</b>                         |         |           |         |            |
| Securities available-for-sale:                   |         |           |         |            |
| U.S. Treasury and other U.S. government agencies | \$      | \$ 30,252 | \$      | \$ 30,252  |
| States and political subdivisions                |         | 32,326    |         | 32,326     |
| Mortgage-backed securities                       |         | 37,403    |         | 37,403     |
| Mortgage servicing rights                        |         |           | 407     | 407        |

**Securities available for sale**

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

Management believes that it has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of securities to enable management to maintain an appropriate system of internal control. On a quarterly basis the Company reviews changes in the market value of its security portfolio. Individual changes in valuations are reviewed for consistency with general interest rate movements and any known credit concerns for specific securities. Additionally, on an annual basis the Company has its entire security portfolio priced by a second pricing service to determine consistency with another market evaluator. If, on the Company's review or in comparing with another servicer, a material difference between pricing evaluations were to exist, the Company may submit an inquiry to the servicing provider regarding the data used to value a particular security. If the Company determines it has market information that would support a different valuation than the initial evaluation it can submit a challenge for a change to that security's valuation. There were no material differences in valuations noted in 2012 or 2011.

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

**Mortgage servicing rights**

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



**Table of Contents**

service's valuation models, assumptions and inputs used in determining the fair value of MSRs to enable management to maintain an appropriate system of internal control. Mortgage servicing rights are classified within Level 3 of the fair value hierarchy as the valuation is model driven and primarily based on unobservable inputs.

The following table summarizes the changes in fair value for mortgage servicing rights during the three and six month periods ended June 30, 2012 and 2011, respectively:

|                             | <b>Three months ended June 30,</b> |             |
|-----------------------------|------------------------------------|-------------|
|                             | <b>2012</b>                        | <b>2011</b> |
| Beginning balance, March 31 | \$ 454                             | \$ 435      |
| Losses included in earnings | (47)                               | (41)        |
| Additions from loan sales   | 41                                 | 48          |
| Ending balance, June 30     | \$ 448                             | \$ 442      |

|                                | <b>Six months ended June 30,</b> |             |
|--------------------------------|----------------------------------|-------------|
|                                | <b>2012</b>                      | <b>2011</b> |
| Beginning balance, December 31 | \$ 407                           | \$ 388      |
| Losses included in earnings    | (54)                             | (36)        |
| Additions from loan sales      | 95                               | 90          |
| Ending balance, June 30        | \$ 448                           | \$ 442      |

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

|                       | <b>6/30/2012</b> | <b>6/30/2011</b> |
|-----------------------|------------------|------------------|
| Servicing fees        | 0.25%            | 0.25%            |
| Discount rate         | 10.08%           | 10.12%           |
| Prepayment rate (CPR) | 15.82%           | 13.07%           |

**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 June 30, 2012 and December 31, 2011:

|                          | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Fair Value</b> |
|--------------------------|----------------|----------------|----------------|-------------------|
| <b>June 30, 2012</b>     |                |                |                |                   |
| Impaired loans           | \$             | \$             | \$ 10,076      | \$ 10,076         |
| <b>December 31, 2011</b> |                |                |                |                   |
| Impaired loans           | \$             | \$             | \$ 10,311      | \$ 10,311         |

**Impaired loans**

The Company evaluates and values impaired loans at the time the loan is identified as impaired, and the fair values of such loans are estimated using Level 3 inputs in the fair value hierarchy. Each loan's collateral has a unique appraisal and management's discount of the value is based on factors unique to each impaired loan. The significant unobservable input in determining the fair value is management's subjective discount on appraisals of the collateral securing the loan, which ranges from 10%-50%. Collateral may consist of real estate and/or business assets including

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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

**Table of Contents**

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 commercial loan being downgraded on the Company internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired commercial loans are either graded a 6 or 7 on the internal loan rating scale. For consumer loans, the Company obtains appraisals when a loan becomes 90 days past due or is determined to be impaired, whichever occurs first. Subsequent to the downgrade or reaching 90 days past due, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change in the condition of the collateral, or feedback from local appraisers. Impaired loans had a gross value of \$11.4 million, with a valuation allowance of \$1.3 million, at June 30, 2012, compared to a gross value for impaired loans of \$11.9 million, with a valuation allowance of \$1.6 million, at December 31, 2011.

**FAIR VALUE OF FINANCIAL INSTRUMENTS**

At June 30, 2012 and December 31, 2011, 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:

|   | June 30, 2012      |               | December 31, 2011  |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
|   | (in thousands)     |               | (in thousands)     |               |
| <b>Financial assets:</b>                      |                    |               |                    |               |
| Level 1:                                      |                    |               |                    |               |
| Cash and cash equivalents                     | \$ 43,985          | \$ 43,985     | \$ 14,678          | \$ 14,678     |
| Level 2:                                      |                    |               |                    |               |
| Available for sale securities                 | 93,094             | 93,094        | 99,981             | 99,981        |
| FHLB and FRB stock                            | 3,238              | 3,238         | 3,255              | 3,255         |
| Level 3:                                      |                    |               |                    |               |
| Held to maturity securities                   | 3,708              | 3,730         | 3,802              | 3,811         |
| Loans and leases, net                         | 587,265            | 621,700       | 571,910            | 602,534       |
| Mortgage servicing rights                     | 448                | 448           | 407                | 407           |
| <b>Financial liabilities:</b>                 |                    |               |                    |               |
| Level 1:                                      |                    |               |                    |               |
| Demand deposits                               | \$ 116,231         | \$ 116,231    | \$ 118,037         | \$ 118,037    |
| NOW deposits                                  | 63,535             | 63,535        | 50,761             | 50,761        |
| Regular savings deposits                      | 342,992            | 342,992       | 313,777            | 313,777       |
| Muni-vest deposits                            | 22,883             | 22,883        | 20,161             | 20,161        |
| Junior subordinated debentures                | 11,330             | 11,330        | 11,330             | 11,330        |
| Commitments to extend credit                  | 64                 | 64            | 161                | 161           |
| Securities sold under agreement to repurchase | 9,855              | 9,855         | 9,010              | 9,010         |
| Level 2:                                      |                    |               |                    |               |
| Other borrowed funds                          | 19,000             | 19,751        | 22,000             | 22,988        |
| Level 3:                                      |                    |               |                    |               |
| Time deposits                                 | 108,279            | 111,558       | 113,467            | 116,666       |

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

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

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

## **Table of Contents**

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

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

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

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

**Commitments to extend credit and standby letters of credit.** As described in Note 8 – Contingent Liabilities and Commitments to these Unaudited Consolidated Financial Statements, the Company was a party to financial instruments with off-balance sheet risk at June 30, 2012 and December 31, 2011. Such financial instruments consist of commitments to extend permanent financing and letters of credit. If the options are exercised by the prospective borrowers, these financial instruments will become interest-earning assets of the Company. If the options expire, the Company retains any fees paid by the counterparty in order to obtain the commitment or guarantee. The fees collected for these commitments are recorded as unearned commitment fees in Other Liabilities. The carrying value approximates the fair value.

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

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

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

### **Loan and Lease Portfolio Composition**

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

**Table of Contents**

|                                     | <b>June 30, 2012</b> | <b>December 31, 2011</b> |
|-------------------------------------|----------------------|--------------------------|
| Mortgage loans on real estate:      |                      | (in thousands)           |
| Residential Mortgages               | \$ 69,332            | \$ 73,579                |
| Commercial and multi-family         | 323,456              | 306,683                  |
| Construction-Residential            | 2,535                | 2,392                    |
| Construction-Commercial             | 31,807               | 27,887                   |
| Home equities                       | 55,445               | 54,673                   |
| <br>Total real estate loans         | <br>482,575          | <br>465,214              |
| Direct financing leases             | 3,355                | 6,021                    |
| Commercial and industrial loans     | 107,807              | 109,513                  |
| Consumer loans                      | 1,551                | 1,677                    |
| Other                               | 2,303                | 586                      |
| Net deferred loan origination costs | 332                  | 394                      |
| <br>Total gross loans               | <br>597,923          | <br>583,405              |
| Allowance for loan losses           | (10,658)             | (11,495)                 |
| <br>Loans, net                      | <br>\$ 587,265       | <br>\$ 571,910           |

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**Table of Contents**

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three and six month periods ended June 30, 2012, the Bank sold mortgages to FNMA totaling \$4.9 million and \$11.1 million, respectively as compared with \$5.8 million and \$13.1 million sold during the three and six month periods ended June 30, 2011, respectively. At June 30, 2012, the Bank had a loan servicing portfolio principal balance of \$68.4 million upon which it earns servicing fees, as compared with \$62.4 million at December 31, 2011. The value of the mortgage servicing rights for that portfolio was \$0.4 million at June 30, 2012 and \$0.4 million at December 31, 2011. Residential mortgage loans held-for-sale were \$1.0 million at June 30, 2012, compared with \$3.6 million at December 31, 2011. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

As noted in Note 1, these financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011. Disclosures related to the basis for accounting for loans and leases, the method for recognizing interest income on loans and leases, the policy for placing loans and leases on nonaccrual status and the subsequent recording of payments and resuming accrual of interest, the policy for determining past due status, a description of the Company's accounting policies and methodology used to estimate the allowance for loan and lease losses, the policy for charging off loans and leases, the accounting policies for impaired loans, and more descriptive information on the Company's credit risk ratings are all contained in the Notes to the Audited Consolidated Financial Statements in the Annual Report on Form 10-K for the year ended December 31, 2011. Unless otherwise noted in this Form 10-Q, the policies and methodology described in the Annual Report for the year ended December 31, 2011 are consistent with those utilized in the six months ended June 30, 2012.

**Credit Quality Indicators**

The Bank monitors the credit risk in its loan portfolio by reviewing certain credit quality indicators ( CQI ). The primary CQI for its commercial mortgage and 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

4-Watch

5-O.A.E.M. (Other Assets Especially Mentioned) or Special Mention

6-Substandard

7-Doubtful

8-Loss

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

**Table of Contents**

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

**June 30, 2012**  
(in thousands)

**Corporate Credit**

| Exposure By<br>Credit Rating | Commercial<br>Real Estate<br>Construction | Commercial<br>Real Estate<br>Other | Total<br>Commercial<br>Real Estate | Commercial and<br>Industrial |
|------------------------------|---|------------------------------------|------------------------------------|------------------------------|
| 3                            | \$ 27,328                                 | \$ 278,067                         | \$ 305,395                         | \$ 79,307                    |
| 4                            | 2,825                                     | 35,953                             | 38,778                             | 19,362                       |
| 5                            | 843                                       | 1,858                              | 2,701                              | 4,415                        |
| 6                            | 811                                       | 3,766                              | 4,577                              | 3,362                        |
| 7                            |   | 3,812                              | 3,812                              | 1,361                        |
| Total                        | \$ 31,807                                 | \$ 323,456                         | \$ 355,263                         | \$ 107,807                   |

**December 31, 2011**  
(in thousands)

**Corporate Credit**

| Exposure By<br>Credit Rating | Commercial<br>Real Estate<br>Construction | Commercial<br>Real Estate<br>Other | Total<br>Commercial<br>Real Estate | Commercial and<br>Industrial |
|------------------------------|---|------------------------------------|------------------------------------|------------------------------|
| 3                            | \$ 21,607                                 | \$ 250,575                         | \$ 272,182                         | \$ 77,017                    |
| 4                            | 4,421                                     | 45,505                             | 49,926                             | 21,448                       |
| 5                            | 362                                       | 1,758                              | 2,120                              | 5,939                        |
| 6                            | 1,497                                     | 8,845                              | 10,342                             | 4,761                        |
| 7                            |   |                                    |                                    | 348                          |
| Total                        | \$ 27,887                                 | \$ 306,683                         | \$ 334,570                         | \$ 109,513                   |

**Table of Contents****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>June 30, 2012</b><br>(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              | \$ 254            | \$ 1,069          | \$ 805          | \$ 2,128              | \$ 105,679             | \$ 107,807           | \$ 2                     | \$ 1,895                             |  |
| Residential real estate:               |                   |                   |                 |                       |                        |                      |                          |                                      |  |
| Residential                            |                   | 269               | 1,183           | 1,452                 | 67,880                 | 69,332               | 241                      | 985                                  |  |
| Construction                           |                   |                   |                 |                       | 2,535                  | 2,535                |                          |                                      |  |
| Commercial real estate:                |                   |                   |                 |                       |                        |                      |                          |                                      |  |
| Commercial                             |                   |                   | 2,136           | 2,136                 | 321,320                | 323,456              | 151                      | 5,504                                |  |
| Construction                           |                   |                   | 811             | 811                   | 30,996                 | 31,807               |                          | 811                                  |  |
| Home equities                          | 154               | 104               | 773             | 1,031                 | 54,414                 | 55,445               | 16                       | 907                                  |  |
| Direct financing leases                | 33                | 14                | 250             | 297                   | 3,058                  | 3,355                |                          | 430                                  |  |
| Consumer                               | 1                 | 4                 | 37              | 42                    | 1,509                  | 1,551                |                          | 66                                   |  |
| Other                                  |                   |                   |                 |                       | 2,635                  | 2,635                |                          |                                      |  |
| <b>Total Loans</b>                     | <b>\$ 442</b>     | <b>\$ 1,460</b>   | <b>\$ 5,995</b> | <b>\$ 7,897</b>       | <b>\$ 590,026</b>      | <b>\$ 597,923</b>    | <b>\$ 410</b>            | <b>\$ 10,598</b>                     |  |

| <b>December 31, 2011</b><br>(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                  | \$ 279            | \$ 94             | \$ 1,702        | \$ 2,075              | \$ 107,438             | \$ 109,513           | \$                       | \$ 2,180                             |  |
| Residential real estate:                   |                   |                   |                 |                       |                        |                      |                          |                                      |  |
| Residential                                | 735               | 55                | 1,062           | 1,852                 | 71,727                 | 73,579               | 73                       | 1,048                                |  |
| Construction                               |                   |                   | 167             | 167                   | 2,225                  | 2,392                |                          | 167                                  |  |
| Commercial real estate:                    |                   |                   |                 |                       |                        |                      |                          |                                      |  |
| Commercial                                 | 3,086             | 64                | 2,686           | 5,836                 | 300,847                | 306,683              | 59                       | 6,858                                |  |
| Construction                               |                   |                   | 2,609           | 2,609                 | 25,278                 | 27,887               | 1,167                    | 1,442                                |  |
| Home equities                              | 481               | 110               | 683             | 1,274                 | 53,399                 | 54,673               |                          | 946                                  |  |
| Direct financing leases                    | 327               | 26                | 754             | 1,107                 | 4,914                  | 6,021                |                          | 1,160                                |  |
| Consumer                                   | 56                | 5                 | 4               | 65                    | 1,612                  | 1,677                |                          | 76                                   |  |
| Other                                      |                   |                   |                 |                       | 980                    | 980                  |                          |                                      |  |
| <b>Total Loans</b>                         | <b>\$ 4,964</b>   | <b>\$ 354</b>     | <b>\$ 9,667</b> | <b>\$ 14,985</b>      | <b>\$ 568,420</b>      | <b>\$ 583,405</b>    | <b>\$ 1,299</b>          | <b>\$ 13,877</b>                     |  |



**Table of Contents****Allowance for loan and lease losses**

The following tables present the activity in the allowance for loan and lease losses according to portfolio segment, for the six month period ended June 30, 2012 and June 30, 2011:

| (in thousands)                              | June 30, 2012                |   |            |                           |        |                               |             |           |
|---|------------------------------|---|------------|---------------------------|--------|-------------------------------|-------------|-----------|
|   | Commercial<br>and Industrial | Commercial<br>Real Estate<br>Mortgages* | Consumer ^ | Residential<br>Mortgages* | HELOC  | Direct<br>Financing<br>Leases | Unallocated | Total     |
| <b>Allowance for loan and lease losses:</b> |                              |   |            |                           |        |                               |             |           |
| Beginning balance                           | \$ 4,085                     | \$ 4,670                                | \$ 36      | \$ 793                    | \$ 768 | \$ 994                        | \$ 149      | \$ 11,495 |
| Charge-offs                                 | (424)                        | (546)                                   | (10)       | 0                         | (13)   | 0                             | 0           | (993)     |
| Recoveries                                  | 70                           | 15                                      | 13         |                           | 6      |                               |             | 104       |
| Provision                                   | \$ 485                       | \$ 238                                  | \$ 9       | (\$95)                    | \$ 42  | (\$627)                       | \$ 0        | 52        |
| Ending balance                              | \$ 4,216                     | \$ 4,377                                | \$ 48      | \$ 698                    | \$ 803 | \$ 367                        | \$ 149      | \$ 10,658 |

**Allowance for loan and lease losses:**

|   |                 |                 |              |               |               |               |               |                  |
|---|-----------------|-----------------|--------------|---------------|---------------|---------------|---------------|------------------|
| Individually evaluated for impairment           | \$ 851          | \$ 252          | \$ 16        | \$ 0          | \$ 102        | \$ 95         | \$ 0          | \$ 1,316         |
| Collectively evaluated for impairment           | 3,365           | 4,125           | 32           | 698           | 701           | 272           | 149           | 9,342            |
| Loans acquired with deteriorated credit quality |                 |                 |              |               |               |               |               |                  |
| <b>Total</b>                                    | <b>\$ 4,216</b> | <b>\$ 4,377</b> | <b>\$ 48</b> | <b>\$ 698</b> | <b>\$ 803</b> | <b>\$ 367</b> | <b>\$ 149</b> | <b>\$ 10,658</b> |

**Loans and leases:**

|   |                   |                   |                 |                  |                  |                 |             |                   |
|---|-------------------|-------------------|-----------------|------------------|------------------|-----------------|-------------|-------------------|
| <b>Ending balance:</b>                          |                   |                   |                 |                  |                  |                 |             |                   |
| Individually evaluated for impairment           | \$ 1,916          | \$ 6,860          | \$ 36           | \$ 985           | \$ 1,234         | \$ 331          | \$ 0        | \$ 11,362         |
| Collectively evaluated for impairment           | 105,891           | 348,403           | 3,788           | 70,882           | 54,211           | 3,024           | 0           | 586,199           |
| Loans acquired with deteriorated credit quality |                   |                   | 30              |                  |                  |                 |             | 30                |
| <b>Total</b>                                    | <b>\$ 107,807</b> | <b>\$ 355,263</b> | <b>\$ 3,854</b> | <b>\$ 71,867</b> | <b>\$ 55,445</b> | <b>\$ 3,355</b> | <b>\$ 0</b> | <b>\$ 597,591</b> |

\* Includes construction loans

^ Includes other loans

Note: Loan and lease balances do not include \$332 thousand in net deferred loan and lease origination costs as of June 30, 2012.

**Table of Contents**

|   |    | June 30, 2011 |   |            |                           |           |                   |             |            |
|---|----|---------------|---|------------|---------------------------|-----------|-------------------|-------------|------------|
|   |    | Commercial    | Commercial<br>Real Estate<br>Mortgages* | Consumer ^ | Residential<br>Mortgages* | HELOC     | Finance<br>Leases | Unallocated | Total      |
| (in thousands)                                  |    |               |   |            |                           |           |                   |             |            |
| <b>Allowance for loan and lease losses:</b>     |    |               |   |            |                           |           |                   |             |            |
| Beginning balance                               | \$ | 3,435         | \$ 4,252                                | \$ 29      | \$ 548                    | \$ 540    | \$ 1,471          | \$ 149      | \$ 10,424  |
| Charge-offs                                     |    | (1,124)       | (\$142)                                 | (\$11)     |                           |           |                   |             | (1,277)    |
| Recoveries                                      |    | 16            |   | 6          |                           | 1         |                   |             | 23         |
| Provision                                       | \$ | 1,244         | \$ 184                                  | \$ 20      | \$ 30                     | \$ 19     | \$ 0              | \$ 0        | 1,497      |
| Ending balance                                  | \$ | 3,571         | \$ 4,294                                | \$ 44      | \$ 578                    | \$ 560    | \$ 1,471          | \$ 149      | \$ 10,667  |
| <b>Allowance for loan and lease losses:</b>     |    |               |   |            |                           |           |                   |             |            |
| Individually evaluated for impairment           | \$ | 209           | \$ 721                                  | \$ 12      | \$ 0                      | \$ 0      | \$ 41             | \$ 0        | \$ 983     |
| Collectively evaluated for impairment           |    | 3,362         | \$ 3,573                                | \$ 32      | 578                       | 560       | 1,430             | 149         | 9,684      |
| Loans acquired with deteriorated credit quality |    |               |   |            |                           |           |                   |             |            |
| Total   | \$ | 3,571         | \$ 4,294                                | \$ 44      | \$ 578                    | \$ 560    | \$ 1,471          | \$ 149      | \$ 10,667  |
| <b>Loans and leases:</b>                        |    |               |   |            |                           |           |                   |             |            |
| Ending balance:                                 |    |               |   |            |                           |           |                   |             |            |
| Individually evaluated for impairment           | \$ | 1,390         | \$ 8,132                                | \$ 58      | \$ 0                      | \$ 0      | \$ 271            | \$ 0        | \$ 9,851   |
| Collectively evaluated for impairment           |    | 99,967        | \$ 295,820                              | \$ 2,544   | 69,833                    | 54,385    | 9,686             |             | 532,235    |
| Loans acquired with deteriorated credit quality |    |               |   | 79         |                           |           |                   |             | 79         |
| Total   | \$ | 101,357       | \$ 303,952                              | \$ 2,681   | \$ 69,833                 | \$ 54,385 | \$ 9,957          | \$          | \$ 542,165 |

\* Includes construction loans

^ Includes other loans

Note: Loan and lease balances do not include \$329 thousand in net deferred loan and lease origination costs as of June 30, 2011.

The following tables present the activity in the allowance for loan and lease losses according to portfolio segment, for the three month period ended June 30, 2012 and June 30, 2011:

|   |    | June 30, 2012                |  |          |                          |        |                               |             |           |
|---|----|------------------------------|--|----------|--------------------------|--------|-------------------------------|-------------|-----------|
|   |    | Commercial<br>and Industrial | Commercial<br>Real Estate<br>Mortgages | Consumer | Residential<br>Mortgages | HELOC  | Direct<br>Financing<br>Leases | Unallocated | Total     |
| (in thousands)                              |    |                              |  |          |                          |        |                               |             |           |
| <b>Allowance for loan and lease losses:</b> |    |                              |  |          |                          |        |                               |             |           |
| Beginning balance                           | \$ | 3,946                        | \$ 4,565                               | \$ 43    | \$ 719                   | \$ 785 | \$ 583                        | \$ 149      | \$ 10,790 |
| Charge-offs                                 |    | (15)                         | (487)                                  | (7)      | 0                        | 0      | 0                             | 0           | (509)     |
| Recoveries                                  |    | 52                           | 15                                     | 9        |                          |        |                               |             | 76        |
| Provision                                   |    | 233                          | 284                                    | 3        | (21)                     | 18     | (216)                         | 0           | 301       |

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|                |          |          |       |        |        |        |        |           |
|----------------|----------|----------|-------|--------|--------|--------|--------|-----------|
| Ending balance | \$ 4,216 | \$ 4,377 | \$ 48 | \$ 698 | \$ 803 | \$ 367 | \$ 149 | \$ 10,658 |
|----------------|----------|----------|-------|--------|--------|--------|--------|-----------|

**Table of Contents**

| (in thousands)                              | June 30, 2011 |                                  |          |                       |        |                |             | Total     |
|---|---------------|----------------------------------|----------|-----------------------|--------|----------------|-------------|-----------|
|   | Commercial    | Commercial Real Estate Mortgages | Consumer | Residential Mortgages | HELOC  | Finance Leases | Unallocated |           |
| <b>Allowance for loan and lease losses:</b> |               |                                  |          |                       |        |                |             |           |
| Beginning balance                           | \$ 3,330      | \$ 4,384                         | \$ 37    | \$ 564                | \$ 547 | \$ 1,471       | \$ 149      | \$ 10,482 |
| Charge-offs                                 | (691)         | (\$142)                          | (\$7)    |                       |        |                |             | (840)     |
| Recoveries                                  | 13            |                                  | 3        |                       |        |                |             | 16        |
| Provision                                   | 919           | 52                               | 11       | 14                    | 13     | 0              | 0           | 1,009     |
| Ending balance                              | \$ 3,571      | \$ 4,294                         | \$ 44    | \$ 578                | \$ 560 | \$ 1,471       | \$ 149      | \$ 10,667 |

In the first quarter of 2012, the Company changed its methodology for reserving for non-accruing residential mortgages and home equities in response to the Interagency Supervisory Guidance. Previously, estimated loss percentages were applied to pools of non-accruing residential mortgages and home equity loans. The Company now evaluates required loss reserves on an individual loan basis. This change resulted from the Company's successful efforts to obtain more information about the financial status of borrowers and the fair value of loan collateral. The change from reserving for non-accruing residential mortgages and home equities on an individual basis versus a pooled approach resulted in a reduction of allowance for loan and lease losses of \$0.1 million.

There were no other changes in the Company's allowance for loan and lease loss methodology in the six month period ended June 30, 2012.

**Table of Contents****Impaired Loans and Leases**

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

|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | At June 30, 2012     |                                   | Interest<br>Income<br>Foregone | Interest<br>Income<br>Recognized |
|--|------------------------|--------------------------------|----------------------|-----------------------------------|--------------------------------|----------------------------------|
|  |                        |                                | Related<br>Allowance | Average<br>Recorded<br>Investment |                                |                                  |
| (in thousands)                             |                        |                                |                      |                                   |                                |                                  |
| <b>With no related allowance recorded:</b> |                        |                                |                      |                                   |                                |                                  |
| Commercial and industrial                  | \$ 252                 | \$ 275                         | \$ 0                 | \$ 265                            | \$ 18                          | \$ 1                             |
| Residential real estate:                   |                        |                                |                      |                                   |                                |                                  |
| Residential                                | 985                    | 1,092                          |                      | 989                               | 36                             | 0                                |
| Construction                               |                        |                                |                      |                                   |                                |                                  |
| Commercial real estate:                    |                        |                                |                      |                                   |                                |                                  |
| Commercial                                 | 2,261                  | 2,886                          |                      | 2,569                             | 100                            |                                  |
| Construction                               |                        |                                |                      |                                   |                                |                                  |
| Home equities                              | 1,028                  | 1,059                          |                      | 1,029                             | 16                             | 5                                |
| Direct financing leases                    |                        |                                |                      |                                   |                                |                                  |
| Consumer                                   |                        |                                |                      |                                   |                                |                                  |
| Other                                      |                        |                                |                      |                                   |                                |                                  |
| <b>Total impaired loans and leases</b>     | <b>\$ 4,526</b>        | <b>\$ 5,312</b>                | <b>\$</b>            | <b>\$ 4,852</b>                   | <b>\$ 170</b>                  | <b>\$ 6</b>                      |

|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | At June 30, 2012     |                                   | Interest<br>Income<br>Foregone | Interest<br>Income<br>Recognized |
|---|------------------------|--------------------------------|----------------------|-----------------------------------|--------------------------------|----------------------------------|
|   |                        |                                | Related<br>Allowance | Average<br>Recorded<br>Investment |                                |                                  |
| (in thousands)                            |                        |                                |                      |                                   |                                |                                  |
| <b>With a related allowance recorded:</b> |                        |                                |                      |                                   |                                |                                  |
| Commercial and industrial                 | \$ 1,664               | \$ 1,728                       | \$ 851               | \$ 1,689                          | \$ 36                          | \$ 0                             |
| Residential real estate:                  |                        |                                |                      |                                   |                                |                                  |
| Residential                               |                        |                                |                      |                                   |                                |                                  |
| Construction                              |                        |                                |                      |                                   |                                |                                  |
| Commercial real estate:                   |                        |                                |                      |                                   |                                |                                  |
| Commercial                                | 3,788                  | 3,929                          | 241                  | 3,797                             | 98                             |                                  |
| Construction                              | 811                    | 867                            | 11                   | 814                               | 13                             |                                  |
| Home equities                             | 206                    | 206                            | 102                  | 170                               | 4                              | 1                                |
| Direct financing leases                   | 331                    | 341                            | 95                   | 394                               | 10                             |                                  |
| Consumer                                  | 66                     | 138                            | 16                   | 68                                | 5                              |                                  |
| Other                                     |                        |                                |                      |                                   |                                |                                  |
| <b>Total impaired loans and leases</b>    | <b>\$ 6,866</b>        | <b>\$ 7,209</b>                | <b>\$ 1,316</b>      | <b>\$ 6,933</b>                   | <b>\$ 166</b>                  | <b>\$ 1</b>                      |

**Table of Contents**

|  | At June 30, 2012       |                                |  |                                   |                                |                                  |
|--|------------------------|--------------------------------|--|-----------------------------------|--------------------------------|----------------------------------|
|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance<br>(in thousands) | Average<br>Recorded<br>Investment | Interest<br>Income<br>Foregone | Interest<br>Income<br>Recognized |
| <b>Total</b>                           |                        |                                |  |                                   |                                |                                  |
| Commercial and industrial              | \$ 1,916               | \$ 2,003                       | \$ 851                                 | \$ 1,954                          | \$ 54                          | \$ 1                             |
| Residential real estate:               |                        |                                |  |                                   |                                |                                  |
| Residential                            | 985                    | 1,092                          |  | 989                               | 36                             |                                  |
| Construction                           |                        |                                |  |                                   |                                |                                  |
| Commercial real estate:                |                        |                                |  |                                   |                                |                                  |
| Commercial                             | 6,049                  | 6,815                          | 241                                    | 6,366                             | 198                            |                                  |
| Construction                           | 811                    | 867                            | 11                                     | 814                               | 13                             |                                  |
| Home equities                          | 1,234                  | 1,265                          | 102                                    | 1,199                             | 20                             | 6                                |
| Direct financing leases                | 331                    | 341                            | 95                                     | 394                               | 10                             |                                  |
| Consumer                               | 66                     | 138                            | 16                                     | 68                                | 5                              |                                  |
| Other                                  |                        |                                |  |                                   |                                |                                  |
| <b>Total impaired loans and leases</b> | <b>\$ 11,392</b>       | <b>\$ 12,521</b>               | <b>\$ 1,316</b>                        | <b>\$ 11,784</b>                  | <b>\$ 336</b>                  | <b>\$ 7</b>                      |

|  | At December 31, 2011   |                                |  |                                   |                                |                                  |
|--|------------------------|--------------------------------|--|-----------------------------------|--------------------------------|----------------------------------|
|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance<br>(in thousands) | Average<br>Recorded<br>Investment | Interest<br>Income<br>Foregone | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded:</b> |                        |                                |  |                                   |                                |                                  |
| Commercial and industrial                  | \$ 261                 | \$ 270                         | \$                                     | \$ 371                            | \$ 9                           | \$ 7                             |
| Residential real estate:                   |                        |                                |  |                                   |                                |                                  |
| Residential                                |                        |                                |  |                                   |                                |                                  |
| Construction                               |                        |                                |  |                                   |                                |                                  |
| Commercial real estate:                    |                        |                                |  |                                   |                                |                                  |
| Commercial                                 | 2,723                  | 2,916                          |  | 2,503                             | 215                            | 44                               |
| Construction                               | 1,442                  | 1,497                          |  | 1,355                             | 48                             | 3                                |
| Home equities                              | 327                    | 327                            |  | 331                               |                                | 9                                |
| Direct financing leases                    |                        |                                |  |                                   |                                |                                  |
| Consumer                                   | 32                     | 95                             |  | 79                                | 7                              |                                  |
| Other                                      |                        |                                |  |                                   |                                |                                  |
| <b>Total impaired loans and leases</b>     | <b>\$ 4,785</b>        | <b>\$ 5,105</b>                | <b>\$</b>                              | <b>\$ 4,639</b>                   | <b>\$ 279</b>                  | <b>\$ 63</b>                     |

**Table of Contents**

|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | At December 31, 2011<br>Average<br>Recorded<br>Investment<br>(in thousands) |                 | Related<br>Allowance | Interest<br>Income<br>Foregone | Interest<br>Income<br>Recognized |
|---|------------------------|--------------------------------|---|-----------------|----------------------|--------------------------------|----------------------------------|
| <b>With a related allowance recorded:</b> |                        |                                |   |                 |                      |                                |                                  |
| Commercial and industrial                 | \$ 1,969               | \$ 2,007                       | \$ 405  | \$ 2,151        | \$ 58                | \$ 36                          |                                  |
| Residential real estate:                  |                        |                                |   |                 |                      |                                |                                  |
| Residential                               |                        |                                |   |                 |                      |                                |                                  |
| Construction                              |                        |                                |   |                 |                      |                                |                                  |
| Commercial real estate:                   |                        |                                |   |                 |                      |                                |                                  |
| Commercial                                | 4,135                  | 4,418                          | 844   | 4,257           | 267                  |                                |                                  |
| Construction                              |                        |                                |   |                 |                      |                                |                                  |
| Home equities                             | 170                    | 170                            | 31  | 170             | 4                    | 2                              |                                  |
| Direct financing leases                   | 847                    | 907                            | 350   | 1,214           | 60                   | 1                              |                                  |
| Consumer                                  | 44                     | 49                             | 9   | 56              | 4                    |                                |                                  |
| Other                                     |                        |                                |   |                 |                      |                                |                                  |
| <b>Total impaired loans and leases</b>    | <b>\$ 7,165</b>        | <b>\$ 7,551</b>                | <b>\$ 1,639</b>   | <b>\$ 7,848</b> | <b>\$ 393</b>        | <b>\$ 39</b>                   |                                  |

|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | At December 31, 2011<br>Average<br>Recorded<br>Investment<br>(in thousands) |                  | Related<br>Allowance | Interest<br>Income<br>Foregone | Interest<br>Income<br>Recognized |
|--|------------------------|--------------------------------|---|------------------|----------------------|--------------------------------|----------------------------------|
| <b>Total</b>                           |                        |                                |   |                  |                      |                                |                                  |
| Commercial and industrial              | \$ 2,230               | \$ 2,277                       | \$ 405  | \$ 2,522         | \$ 67                | \$ 43                          |                                  |
| Residential real estate:               |                        |                                |   |                  |                      |                                |                                  |
| Residential                            |                        |                                |   |                  |                      |                                |                                  |
| Construction                           |                        |                                |   |                  |                      |                                |                                  |
| Commercial real estate:                |                        |                                |   |                  |                      |                                |                                  |
| Commercial                             | 6,858                  | 7,334                          | 844   | 6,760            | 482                  | 44                             |                                  |
| Construction                           | 1,442                  | 1,497                          |   | 1,355            | 48                   | 3                              |                                  |
| Home equities                          | 497                    | 497                            | 31  | 501              | 4                    | 11                             |                                  |
| Direct financing leases                | 847                    | 907                            | 350   | 1,214            | 60                   | 1                              |                                  |
| Consumer                               | 76                     | 144                            | 9   | 135              | 11                   |                                |                                  |
| Other                                  |                        |                                |   |                  |                      |                                |                                  |
| <b>Total impaired loans and leases</b> | <b>\$ 11,950</b>       | <b>\$ 12,656</b>               | <b>\$ 1,639</b>   | <b>\$ 12,487</b> | <b>\$ 672</b>        | <b>\$ 102</b>                  |                                  |

**Table of Contents****Non-performing loans and leases**

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

|   | June 30, 2012    | December 31, 2011 |
|---|------------------|-------------------|
|   | (in thousands)   |                   |
| <b>Non-accruing loans and leases:</b>                           |                  |                   |
| Commercial and industrial loans                                 | \$ 1,895         | \$ 2,180          |
| <b>Residential real estate:</b>                                 |                  |                   |
| Residential   | 985              | 1,048             |
| Construction  |                  | 167               |
| <b>Commercial real estate:</b>                                  |                  |                   |
| Commercial and multi-family                                     | 5,504            | 6,858             |
| Construction  | 811              | 1,442             |
| Home equities   | 907              | 946               |
| Direct financing leases   | 430              | 1,160             |
| Consumer loans  | 66               | 76                |
| Other   |                  |                   |
| <b>Total non-accruing loans and leases</b>                      | <b>\$ 10,598</b> | <b>\$ 13,877</b>  |
| Accruing loans 90+ days past due                                | 410              | 1,299             |
| <b>Total non-performing loans and leases</b>                    | <b>\$ 11,008</b> | <b>\$ 15,176</b>  |
| Total non-performing loans and leases to total assets           | 1.41%            | 2.05%             |
| Total non-performing loans and leases to total loans and leases | 1.84%            | 2.60%             |



**Table of Contents****Troubled debt restructurings**

The Company had \$7.9 million in loans and leases that were restructured in a troubled debt restructuring ( TDR ) at June 30, 2012, compared with \$7.7 million at December 31, 2011. \$6.8 million and \$7.1 million of those balances were in non-accrual status at June 30, 2012 and December 31, 2011, 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 June 30, 2012 and December 31, 2011. None of the restructurings were made under a government assistance program. Two commercial mortgages with a combined balance of \$0.3 million and one residential mortgage with a balance of \$44 thousand are covered under the Bank's loss-sharing arrangement with the FDIC. 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. Modifications made to loans in a troubled debt restructuring did not have a material impact on the Company's net income for the three and six month periods ended June 30, 2012 and 2011. The reserve for a 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. This reserve methodology is used because all TDR loans are considered impaired. As of June 30, 2012, there were no commitments to lend additional funds to debtors owing loans or leases whose terms have been modified in TDRs. The following tables summarize the loans and leases that were classified as troubled debt restructurings as of the dates indicated:

|  | June 30, 2012<br>(\$ in thousands) |             |          | Related<br>Allowance |
|--|------------------------------------|-------------|----------|----------------------|
|  | Total                              | Nonaccruing | Accruing |                      |
| Commercial and industrial                    | \$ 1,609                           | \$ 1,588    | \$ 21    | \$ 712               |
| Residential real estate:                     |                                    |             |          |                      |
| Residential                                  | 44                                 | 44          |          |                      |
| Construction                                 |                                    |             |          |                      |
| Commercial real estate:                      |                                    |             |          |                      |
| Commercial and multi family                  | 5,621                              | 5,076       | 545      | 190                  |
| Construction                                 |                                    |             |          |                      |
| Home equities                                | 327                                |             | 327      |                      |
| Direct financing leases                      | 331                                | 138         | 193      | 95                   |
| Consumer loans                               |                                    |             |          |                      |
| Other  |                                    |             |          |                      |
| Total troubled restructured loans and leases | \$ 7,932                           | \$ 6,846    | \$ 1,086 | \$ 997               |

**Table of Contents**

|  | December 31, 2011<br>(\$ in thousands) |             |          |                   |
|--|--|-------------|----------|-------------------|
|  | Total                                  | Nonaccruing | Accruing | Related Allowance |
| Commercial and industrial                    | \$ 1,432                               | \$ 1,362    | \$ 70    | \$ 64             |
| Residential real estate:                     |  |             |          |                   |
| Residential                                  |  |             |          |                   |
| Construction                                 |  |             |          |                   |
| Commercial real estate:                      |  |             |          |                   |
| Commercial and multi family                  | 5,258                                  | 5,258       |          | 708               |
| Construction                                 |  |             |          |                   |
| Home equities                                | 327                                    |             | 327      |                   |
| Direct financing leases                      | 714                                    | 439         | 275      | 330               |
| Consumer loans                               |  |             |          |                   |
| Other  |  |             |          |                   |
| Total troubled restructured loans and leases | \$ 7,731                               | \$ 7,059    | \$ 672   | \$ 1,102          |

The following table shows the data for TDR activity for the three and six month periods ended June 30, 2012:

| Troubled Debt             | Three Months Ended June 30, 2012<br>(\$ in thousands) |  |   | Six Months Ended June 30, 2012<br>(\$ in thousands) |  |   |
|---------------------------|---|--|---|---|--|---|
|                           | Number of Contracts                                   | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Contracts                                 | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Restructurings            |   |  |   |   |  |   |
| Commercial and Industrial |   |  |   | 2   | \$ 256   | \$ 256  |
| Residential Real Estate:  |   |  |   |   |  |   |
| Residential               | 1   | 44   | 44  | 1   | 44   | 44  |
| Construction              |   |  |   |   |  |   |
| Commercial Real Estate:   |   |  |   |   |  |   |
| Commercial & Multi-Family | 1   | 637  | 637   | 2   | 722  | 722   |
| Construction              |   |  |   |   |  |   |
| Home Equities             |   |  |   |   |  |   |
| Direct financing leases   |   |  |   |   |  |   |
| Consumer loans            |   |  |   |   |  |   |
| Other                     |   |  |   |   |  |   |

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 and the loan or lease is determined to be uncollectible, the loan or lease will be charged off. The following table presents loans and leases which were classified as TDR s during the previous 12 months which have defaulted during the three and six month periods ended June 30, 2012:

**Table of Contents**

| Troubled Debt Restructurings | Three Months Ended June 30, 2012 |                     | Six Months Ended June 30, 2012 |                     |
|------------------------------|----------------------------------|---------------------|--------------------------------|---------------------|
|                              | Number of Contracts              | Recorded Investment | Number of Contracts            | Recorded Investment |
| That Subsequently Defaulted  |                                  |                     |                                |                     |
| Commercial and Industrial    |                                  |                     | 4                              | \$ 1,272            |
| Residential Real Estate:     |                                  |                     |                                |                     |
| Residential                  |                                  |                     |                                |                     |
| Construction                 |                                  |                     |                                |                     |
| Commercial Real Estate:      |                                  |                     |                                |                     |
| Commercial and Multi-Family  |                                  |                     | 6                              | 4,289               |
| Construction                 |                                  |                     |                                |                     |
| Home Equities                |                                  |                     |                                |                     |
| Direct financing leases      |                                  |                     |                                |                     |

**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 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 June 30, 2012 and December 31, 2011 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 June 30, 2012 and December 31, 2011:

|   | June 30, 2012  | December 31, 2011 |
|---|----------------|-------------------|
|   | (in thousands) |                   |
| Covered loans   | \$ 23,408      | \$ 26,429         |
| Incremental estimated credit losses since acquisition | 578            | 506               |
| FDIC guarantee  | (462)          | (405)             |
| Allowance for loan and lease losses                   | \$ 116         | \$ 101            |

**5. PER SHARE DATA**

The common stock per share information is based upon the weighted average number of shares outstanding during each period. For the three and six month periods ended June 30, 2012 the Company had 17,063 and 8,979 dilutive shares, respectively. The Company had 6,170 and 7,739 dilutive shares for the three and six month periods ended June 30, 2011, 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 and six month periods ended June 30, 2012 there were approximately 162,414 and 167,994 shares, respectively, that were not included in calculating diluted earnings per share because their effect was anti-dilutive. There were 170,706 and 117,186 potentially anti-dilutive shares for the three and six month periods ended June 30, 2011.

**Table of Contents****6. OTHER COMPREHENSIVE INCOME**

The following tables display the components of other comprehensive income (loss):

|  | <b>Three months ended June 30, 2012</b> |   |                              |
|--|---|---|------------------------------|
|  | <b>Before-Tax<br/>Amount</b>            | <b>Income Tax<br/>(Provision)<br/>Benefit</b> | <b>Net-of-Tax<br/>Amount</b> |
| Unrealized gain on investment securities | \$ 23                                   | (\$9)   | \$ 14                        |
| Defined benefit pension plans:           |   |   |                              |
| Amortization of prior service cost       | 22                                      | (9)   | 13                           |
| Amortization of actuarial loss           | 43                                      | (17)  | 26                           |
| <b>Total</b>                             | <b>65</b>                               | <b>(26)</b>                                   | <b>39</b>                    |
| Other Comprehensive Income               | \$ 88                                   | (\$35)  | \$ 53                        |

|  | <b>Three months ended June 30, 2011</b> |   |                              |
|--|---|---|------------------------------|
|  | <b>Before-Tax<br/>Amount</b>            | <b>Income Tax<br/>(Provision)<br/>Benefit</b> | <b>Net-of-Tax<br/>Amount</b> |
| Unrealized gain on investment securities | \$ 1,210                                | (\$469)                                       | \$ 741                       |
| Defined benefit pension plans:           |   |   |                              |
| Amortization of prior service cost       | 22                                      | (9)   | 13                           |
| Amortization of actuarial loss           | 9                                       | (3)   | 6                            |
| <b>Total</b>                             | <b>31</b>                               | <b>(12)</b>                                   | <b>19</b>                    |
| Other Comprehensive Income               | \$ 1,241                                | (\$481)                                       | \$ 760                       |

|  | <b>Six months ended June 30, 2012</b> |   |                              |
|--|---------------------------------------|---|------------------------------|
|  | <b>Before-Tax<br/>Amount</b>          | <b>Income Tax<br/>(Provision)<br/>Benefit</b> | <b>Net-of-Tax<br/>Amount</b> |
| Unrealized loss on investment securities | (\$165)                               | \$ 64   | (\$101)                      |
| Defined benefit pension plans:           |                                       |   |                              |
| Amortization of prior service cost       | 44                                    | (17)  | 27                           |
| Amortization of actuarial loss           | 86                                    | (34)  | 52                           |
| <b>Total</b>                             | <b>130</b>                            | <b>(51)</b>                                   | <b>79</b>                    |
| Other Comprehensive Loss                 | (\$35)                                | \$ 13   | (\$22)                       |

**Table of Contents**

|  | <b>Six months ended June 30, 2011</b> |   |                              |
|--|---------------------------------------|---|------------------------------|
|  | <b>Before-Tax<br/>Amount</b>          | <b>Income Tax<br/>(Provision)<br/>Benefit</b> | <b>Net-of-Tax<br/>Amount</b> |
| Unrealized gain on investment securities | \$ 1,412                              | (\$547)                                       | \$ 865                       |
| Defined benefit pension plans:           |                                       |   |                              |
| Amortization of prior service cost       | 44                                    | (17)  | 27                           |
| Amortization of actuarial loss           | 19                                    | (7)   | 12                           |
| <b>Total</b>                             | <b>63</b>                             | <b>(24)</b>                                   | <b>39</b>                    |
| Other Comprehensive Income               | \$ 1,475                              | (\$571)                                       | \$ 904                       |

**7. 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 and six month periods ended June 30, 2012 and 2011.

|   | <b>Three Months Ended June 30, 2012</b> |  |              |
|---|---|--|--------------|
|   | (in thousands)                          |  |              |
|   | <b>Banking Activities</b>               | <b>Insurance Agency<br/>Activities</b> | <b>Total</b> |
| Net interest income (expense)   | \$ 6,912                                | (31)                                   | \$ 6,881     |
| Provision for loan and lease losses                                     | 301                                     |  | 301          |
| Net interest income (expense) after provision for loan and lease losses | 6,611                                   | (31)                                   | 6,580        |
| Non-interest income   | 1,395                                   |  | 1,395        |
| Insurance service and fees  |   | 1,643                                  | 1,643        |
| Non-interest expense  | 6,060                                   | 1,263                                  | 7,323        |
| Income before income taxes  | 1,946                                   | 349                                    | 2,295        |
| Income tax provision  | 661                                     | 139                                    | 800          |
| Net income  | \$ 1,285                                | \$ 210                                 | \$ 1,495     |

**Table of Contents**

| <b>Three Months Ended June 30, 2011</b>                                 |                           |                                    |              |
|---|---------------------------|------------------------------------|--------------|
| (in thousands)  |                           |                                    |              |
|   | <b>Banking Activities</b> | <b>Insurance Agency Activities</b> | <b>Total</b> |
| Net interest income (expense)   | \$ 6,316                  | (\$29)                             | \$ 6,287     |
| Provision for loan and lease losses                                     | 1,009                     |                                    | 1,009        |
| Net interest income (expense) after provision for loan and lease losses | 5,307                     | (29)                               | 5,278        |
| Non-interest income   | 1,324                     |                                    | 1,324        |
| Insurance service and fees  |                           | 1,601                              | 1,601        |
| Non-interest expense  | 5,348                     | 1,414                              | 6,762        |
| Income before income taxes  | 1,283                     | 158                                | 1,441        |
| Income tax provision  | 408                       | 61                                 | 469          |
| Net income  | \$ 875                    | \$ 97                              | \$ 972       |

| <b>Six Months Ended June 30, 2012</b>                                   |                           |                                    |              |
|---|---------------------------|------------------------------------|--------------|
| (in thousands)  |                           |                                    |              |
|   | <b>Banking Activities</b> | <b>Insurance Agency Activities</b> | <b>Total</b> |
| Net interest income (expense)   | \$ 13,795                 | (\$62)                             | \$ 13,733    |
| Provision for loan and lease losses                                     | 52                        |                                    | 52           |
| Net interest income (expense) after provision for loan and lease losses | 13,743                    | (62)                               | 13,681       |
| Non-interest income   | 2,738                     |                                    | 2,738        |
| Insurance service and fees  |                           | 3,589                              | 3,589        |
| Non-interest expense  | 11,727                    | 2,505                              | 14,232       |
| Income before income taxes  | 4,754                     | 1,022                              | 5,776        |
| Income tax provision  | 1,503                     | 399                                | 1,902        |
| Net income  | \$ 3,251                  | \$ 623                             | \$ 3,874     |

**Table of Contents**

|  | Six Months Ended June 30, 2011 |                                |           |
|--|--------------------------------|--------------------------------|-----------|
|  | (in thousands)                 |                                |           |
|  | Banking Activities             | Insurance Agency<br>Activities | Total     |
| Net interest income (expense)  | \$ 12,642                      | (\$59)                         | \$ 12,583 |
| Provision for loan and lease losses  | 1,497                          |                                | 1,497     |
| Net interest income (expense) after provision for loan<br>and lease losses | 11,145                         | (59)                           | 11,086    |
| Non-interest income  | 2,696                          |                                | 2,696     |
| Insurance service and fees   |                                | 3,690                          | 3,690     |
| Non-interest expense   | 10,629                         | 2,737                          | 13,366    |
| Income before income taxes   | 3,212                          | 894                            | 4,106     |
| Income tax provision   | 914                            | 345                            | 1,259     |
| Net income   | \$ 2,298                       | \$549                          | \$ 2,847  |

**8. 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:

|                              | June 30, 2012  | December 31, 2011 |         |
|------------------------------|----------------|-------------------|---------|
|                              | (in thousands) |                   |         |
| Commitments to extend credit | \$ 145,052     | \$                | 134,204 |
| Standby letters of credit    | 3,227          |                   | 3,429   |
| Total                        | \$ 148,279     | \$                | 137,633 |

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 and has not recorded a reserve for its commitments during 2011 and 2012.

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 June 30, 2012 and December 31, 2011, there were no claims pending against the Company that management considered material.

**Table of Contents****9. 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 Bank contributed \$310 thousand to the defined benefit pension plan in the second quarter of 2012 and plans to contribute an additional \$60 thousand before the end of the year.

The following table presents the net periodic cost for the Bank's defined benefit pension plan and supplemental executive retirement plan for the three and six month periods ended June 30, 2012 and 2011:

|                                    | <b>Three months ended June 30,</b> |      |   |        |
|------------------------------------|------------------------------------|------|---|--------|
|                                    | (in thousands)                     |      |   |        |
|                                    | <b>Pension Benefits</b>            |      | <b>Supplemental Executive Retirement Plan</b> |        |
|                                    | 2012                               | 2011 | 2012  | 2011   |
| Service cost                       | \$                                 | \$   | \$ 45   | \$ 45  |
| Interest cost                      | 53                                 | 55   | 38  | 47     |
| Expected return on plan assets     | (57)                               | (57) |   |        |
| Amortization of prior service cost |                                    |      | 22  | 22     |
| Amortization of the net loss       | 16                                 | 6    | 27  | 3      |
| Net periodic cost                  | \$ 12                              | \$ 4 | \$ 132  | \$ 117 |



**Table of Contents**

|                                    | Six months ended June 30,<br>(in thousands) |       |  |        |
|------------------------------------|---|-------|--|--------|
|                                    | Pension Benefits                            |       | Supplemental Executive Retirement Plan |        |
|                                    | 2012  | 2011  | 2012                                   | 2011   |
| Service cost                       | \$  | \$    | \$ 90                                  | \$ 90  |
| Interest cost                      | 106   | 109   | 76                                     | 95     |
| Expected return on plan assets     | (114)                                       | (114) |  |        |
| Amortization of prior service cost |   |       | 44                                     | 44     |
| Amortization of the net loss       | 32  | 13    | 54                                     | 5      |
| Net periodic cost                  | \$ 24                                       | \$ 8  | \$ 264                                 | \$ 234 |

**10. RECENT ACCOUNTING PRONOUNCEMENTS**

**Accounting Standards Update ( ASU ) 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*.** This ASU relates to accounting for repurchase agreements ( repos ) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. During the global economic crisis, capital market participants questioned the necessity and usefulness of the collateral maintenance guidance for the transferor's ability criterion when determining whether a repo should be accounted for as a sale or as a secured borrowing. The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. The new guidance is effective for interim and annual periods beginning after December 15, 2011. The Company adopted this ASU effective January 1, 2012, which did not have a significant impact on the Company's repo accounting.

**ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards ( IFRS )*.** This ASU was issued to provide largely identical guidance about fair value measurement and disclosure requirements for IFRS and U.S. GAAP. The new guidance clarifies that the application of the highest and best use and valuation premise concepts are not relevant when measuring the fair value of financial assets or liabilities. This ASU also requires new and enhanced disclosures on the quantification and valuation process for significant unobservable inputs, transfers between Levels 1 and 2 and the categorization of all fair value measurements in the fair value hierarchy, even when those measurements are only for disclosure purposes. The Company adopted this ASU effective January 1, 2012. The enhanced disclosures are included in Note 3, Fair Value Measurements.

**ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*.** The objective of this ASU is to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate the convergence of U.S. GAAP and IFRS, the Financial Accounting Standards Board ( FASB ) decided to eliminate the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. The amendments in this ASU will be applied retrospectively. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. In the interim period ended March 31, 2012, the Company adopted this ASU and elected to use the two-statement approach.

**Table of Contents**

**ASU No. 2011-08, *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment*.** This ASU permits an entity to make a qualitative assessment of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before applying the two-step goodwill impairment test. If an entity concludes it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it need not perform the two-step impairment test. The ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company adopted this ASU effective January 1, 2012. The Company will evaluate the need for a two-step goodwill impairment test each period subsequent to adoption. The Company typically performs its goodwill impairment test as of December 31<sup>st</sup> on an annual basis. As there were no triggering events in the quarter ended June 30, 2012, management did not test goodwill for impairment. The Company does not expect adoption of this ASU to have a material effect on its financial statements.

**ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*.** ASU No. 2011-12 defers the effective date of the requirement to present separate line items on the income statement for reclassification adjustments of items out of accumulated other comprehensive income into net income for all periods presented. The ASU does not change the other requirements of FASB ASU No. 2011-05, *Presentation of Comprehensive Income*. Entities are still required to present reclassification adjustments within other comprehensive income either on the face of the statement that reports other comprehensive income or in the notes to the financial statements. The requirement to present comprehensive income in either a single continuous statement or two consecutive condensed statements remains for both annual and interim reporting. The deferral of the requirement for the presentation of reclassification adjustments is intended to be temporary until the FASB reconsiders the operational concerns and needs of financial statement users.

The Company adopted the amendments in this Update at the same time as ASU 2011-05, which became effective beginning in the interim period ended March 31, 2012. As the Company had no reclassifications adjustments within other comprehensive income, this Update had no impact on its financial statements.

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**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, monetary policy, 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, 2011. 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

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## **Table of Contents**

Report on Form 10-K for the year ended December 31, 2011. 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, 2011, 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. There were no triggering events in the three and six month periods ended June 30, 2012 that resulted in an interim impairment test.

## **ANALYSIS OF FINANCIAL CONDITION**

### **Loan and Lease Activity**

Total loans and leases grew to \$597.9 million at June 30, 2012, reflecting an \$18.2 million or 3.1% increase from March 31, 2012 and a \$14.5 million or 2.5% increase from December 31, 2011. The national direct financing lease portfolio declined \$1.1 million during the second quarter to \$3.4 million at June 30, 2012 as the Company ceased lease originations in the second quarter of 2009 and is winding down the portfolio and exiting this business line.

Core loans, defined as total loans less leases, were \$594.6 million at June 30, 2012, a \$19.4 million, or 3.4% increase from \$575.2 million at March 31, 2012 and a \$17.2 million, or 3.0% increase from December 31, 2011. The large amount of loans closed in the fourth quarter of 2011 left the Company's loan pipeline relatively lighter to start 2012. The Company re-filled the pipeline in the first quarter and early second quarter and was able to generate significant loan closings in the second quarter, with the highest level of growth coming in commercial and multi-family real estate loans. Compared with gross core loan balances of \$532.2 million at June 30, 2011, the growth rate over the past twelve months has been 11.7%.

Loans secured by real estate were \$482.6 million at June 30, 2012, an increase of \$12.8 million or 2.7% from March 31, 2012, and \$17.4 million or 3.7% from December 31, 2011. The strongest growth was in commercial and multi-family real estate loans, which increased \$12.4 million or 4.0% in the second quarter of 2012. Year-to-date, growth in commercial real estate was \$16.8 million, or 5.5%. Commercial real estate lending has long been a strength of the Bank and its loan officers and the historical strong performance has continued in 2012.

**Table of Contents**

Residential mortgages decreased to \$69.3 million at June 30, 2012, compared with \$71.7 million at March 31, 2012 and \$73.6 million at December 31, 2011. The Company has sold the majority of its originated residential mortgage loans as long-term fixed rate mortgage loan rates remain near all-time historic lows. This, along with prepayments from existing customers re-financing their homes, has resulted in the decrease in residential mortgage balances in 2012. Residential mortgage originations declined to \$7.1 million and \$14.4 million in the three and six month periods ended June 30, 2012, respectively, compared with \$8.6 million and \$17.6 million in the three and six month periods ended June 30, 2011, respectively, as the Company has been less aggressive in pricing its mortgage products in 2012.

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three and six month periods ended June 30, 2012, the Bank sold mortgages to FNMA totaling \$4.9 million and \$11.1 million, respectively as compared with \$5.8 million and \$13.1 million sold during the three and six month periods ended June 30, 2011, respectively. At June 30, 2012, the Bank had a loan servicing portfolio principal balance of \$68.4 million upon which it earns servicing fees, as compared with \$67.0 million at March 31, 2012 and \$62.4 million at December 31, 2011. The value of the mortgage servicing rights for that portfolio was \$0.4 million at June 30, 2012, March 31, 2012 and December 31, 2011. Residential mortgage loans held-for-sale were \$1.0 million at June 30, 2012, compared with \$1.4 million at March 31, 2012 and \$3.6 million at December 31, 2011. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

The Company continues to focus on commercial and industrial ( C&I ) lending as a way to diversify its loan portfolio, which has historically experienced strong growth rates in real estate loans. However, the Company faces the headwinds of a low growth economy and a very competitive local market. With line of credit usage down at March 31, 2012 compared with December 31, 2011, C&I loans had declined from \$109.5 million to \$103.1 million. Line of credit commitments and line of credit usage both increased in the second quarter, resulting in C&I balances growing to \$107.8 million at June 30, 2012.

**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 June 30, 2012, 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 second quarter of 2012, \$351 thousand in leases were written off and the difference between the principal value and carrying value of the leasing portfolio declined from \$0.4 million to \$0.1 million. While second quarter write-offs were at their highest point in the last five quarters, the charge-offs were not totally unexpected. The Company has consistently maintained a significant reserve for non-performing leases. Non-performing leases of \$0.4 million at June 30, 2012 declined from \$1.0 million at March 31, 2012 and \$1.2 million at December 31, 2011. There were no leases placed in nonaccrual in the second quarter. With both performing and non-performing lease balances declining, management determined that the allowance for leasing losses should decrease by \$0.2 million in the second quarter of 2012, following a \$0.4 million decrease in the first quarter of 2012. 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)          |           |              |               |           |
|--|----------------------------|-----------|--------------|---------------|-----------|
|  | 2012                       |           | 2011         |               |           |
|  | June 30,                   | March 31, | December 31, | September 30, | June 30,  |
| Leasing Principal Balance                  | \$ 3,445                   | \$ 4,953  | \$ 6,509     | \$ 8,467      | \$ 10,736 |
| Mark                                       | (90)                       | (441)     | (488)        | (684)         | (779)     |
| Leasing Carrying Value                     | \$ 3,355                   | \$ 4,512  | \$ 6,021     | \$ 7,783      | \$ 9,957  |
| Mark-to-Market Adjustment                  | \$ 441                     | \$ 488    | \$ 684       | \$ 779        | \$ 890    |
| Net Write-Offs                             | (351)                      | (47)      | (196)        | (95)          | (111)     |
| Remaining Mark                             | \$ 90                      | \$ 441    | \$ 488       | \$ 684        | \$ 779    |
|  | For the three months ended |           |              |               |           |
|  | 2012                       | 2012      | December     | 2011          | June 30,  |
|  | June 30,                   | March     | 31,          | September     | 30,       |
| Allowance for lease losses                 | \$ 583                     | \$ 994    | \$ 1,229     | \$ 1,471      | \$ 1,471  |
| Provision for leases                       | (216)                      | (411)     | (235)        | (242)         |           |
| Leasing net charge-offs                    |                            |           |              |               |           |
| Allowance for lease losses                 | \$ 367                     | \$ 583    | \$ 994       | \$ 1,229      | \$ 1,471  |
| Total mark plus allowance                  | \$ 457                     | \$ 1,024  | \$ 1,482     | \$ 1,913      | \$ 2,250  |
| Mark + allowance/leasing principal balance | 13.27%                     | 20.67%    | 22.77%       | 22.59%        | 20.96%    |

**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 \$11.0 million, or 1.84% of total loans and leases outstanding, at June 30, 2012, compared with \$13.0 million, or 2.25%, at March 31, 2012 and \$15.2 million, or 2.60% of total loans and leases outstanding at December 31, 2011. There were several reasons for the decline in non-performing loans and leases during the past two quarters.

The primary reason for the decrease in the first quarter was related to two commercial constructions loans which totaled \$1.2 million as of December 31, 2011. These loans were converted to permanent loans that were current and accruing as of March 31, 2012 and June 30, 2012, but were 90 days past their maturity date as of December 31, 2011 due to administrative delays in closing the permanent loans. Also in the first quarter, two previously non-accruing residential construction loans with a combined balance of \$0.2 million were converted to permanent residential mortgage loans and were current and performing as of March 31, 2012 and June 30, 2012. The remaining decrease in the first quarter was from payoffs (\$0.3 million), continued improvement in leasing (\$0.2 million), and charge-offs (\$0.2 million).

In the second quarter, in addition to further decreases in leasing non-accruals of \$0.5 million, a non-accruing commercial construction loan for \$0.6 million paid off, a previously non-accruing commercial real estate loan for \$0.5 million was moved to accrual status after six months of timely payments, and there was the partial charge-off of a commercial real estate loan of \$0.4 million. For the loan that was partially charged off, \$0.5 million remains outstanding after the borrower received an offer on the property that serves as the Company's collateral.

The allowance for loan and lease losses totaled \$10.7 million, or 1.78% of total loans and leases outstanding as of June 30, 2012, compared with \$10.8 million or 1.86% at March 31, 2012, and \$11.5 million or 1.97% at December 31, 2011. The decrease in the allowance over the prior year resulted from a \$0.6 million release of reserves on the leasing portfolio and net charge-offs of \$0.9 million in the six month period ended June 30, 2012, partially offset by a \$0.7 million provision for loan losses. The provision for loan losses resulted from the charge-off of three loans that exceeded the reserve associated with those loans at the time of the charge-offs, as well as the loan growth in the second quarter. The \$0.4 million in net charge-offs in the second quarter of 2012 equates to a 0.30% annualized ratio as a percentage of average net loans and leases. This compares with a 0.32% ratio in the first quarter of 2012 and 0.63% in the second quarter of 2011. For the six months ended June 30, 2012, the \$0.9 million in net charge-



**Table of Contents**

offs equated to 0.31% of average net loans and leases, compared with \$1.3 million in net charge-offs for a ratio of 0.47% in the first six months of 2011.

The coverage ratio of the allowance for loan and lease losses to non-performing loans and leases increased from 76% at December 31, 2011 to 83% at March 31, 2012 and 97% at June 30, 2012. There are two factors that significantly influence these ratios. The first factor is the covered loan portfolio acquired in the Waterford transaction which are covered by an FDIC loss-sharing agreement that guarantees 80% of any losses incurred in the portfolio up \$5.6 million, and 95% of losses beyond that threshold. 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:

|                   | June 30, 2012<br>(\$ 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 | \$ 571,160                         | \$ 10,175                           | \$ 8,586                        | 1.78%  | 1.50%  | 118.51%   |
| Covered loans     | 23,408                             | 116                                 | 1,992                           | 0.50%  | 8.51%  | 5.82%   |
| Leases            | 3,355                              | 367                                 | 430                             | 10.94%   | 12.82%   | 85.35%  |
| Total             | \$ 597,923                         | \$ 10,658                           | \$ 11,008                       | 1.78%  | 1.84%  | 96.82%  |

|                   | December 31, 2011<br>(\$ 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 | \$ 550,955                             | \$ 10,400                           | \$ 11,488                       | 1.89%  | 2.09%  | 90.53%  |
| Covered loans     | 26,429                                 | 101                                 | 2,528                           | 0.38%  | 9.57%  | 4.00%   |
| Leases            | 6,021                                  | 994                                 | 1,160                           | 16.51%   | 19.27%   | 85.69%  |
| Total             | \$ 583,405                             | \$ 11,495                           | \$ 15,176                       | 1.97%  | 2.60%  | 75.74%  |

**Investing Activities**

Total securities were \$96.8 million at June 30, 2012, compared with \$112.5 million at March 31, 2012 and \$103.8 million at December 31, 2011. The reduction in the investment securities portfolio from March 31, 2012 reflects the use of excess liquidity garnered in the first quarter 2012 to fund the loan growth in the second quarter 2012. The growth in securities in the first quarter of 2012 was primarily in short-term U.S. Treasury bonds with the expectation of deployment into loans in the second quarter 2012. Interest-bearing deposits at other banks, which consist of overnight funds kept at correspondent banks, increased from \$3.2 million at December 31, 2011 to \$31.9 million at March 31, 2012 and \$31.4 million at June 30, 2012. Interest-bearing cash has increased as deposit growth outpaced loan growth. The Company plans to eventually deploy these short-term investments into loans. Securities and interest-bearing deposits at correspondent banks made up 19.6 % of the Bank's total average interest earning assets in the second quarter of 2012, compared with 18.4% in the first quarter of 2012.



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The Company's highest concentration in its securities portfolio is in government-sponsored mortgage-backed securities with 37.1% at June 30, 2012, compared with 36.0% at December 31, 2011. Tax-advantaged municipal bonds comprised 36.7% of the total portfolio at June 30, 2012, compared with 34.8% at December 31, 2011, while

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**Table of Contents**

the concentration in U.S. government-sponsored agency bonds was 26.1% of the portfolio at June 30, 2012, compared with 29.2% of the portfolio at December 31, 2011.

The credit quality of the securities portfolio as a whole is believed to be strong as the portfolio has no individual securities in a significant unrealized loss position. With interest rates remaining near historic lows, the net unrealized gain position of the investment portfolio decreased slightly from \$4.1 million at December 31, 2011 to \$4.0 million at June 30, 2012. However, this was an increase from \$3.9 million at March 31, 2012.

The Company monitors extension and prepayment risk in the securities portfolio to limit potential exposures. Available-for-sale securities with a total fair value of \$75.2 million at June 30, 2012, as compared with \$76.7 million at December 31, 2011, 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 June 30, 2012 were \$653.9 million, reflecting a \$4.2 million or 0.7% increase from March 31, 2012 and a \$37.7 million, or 6.1%, increase from December 31, 2011. Total demand deposits at June 30, 2012 were \$116.2 million, reflecting a \$1.8 million or 1.6% increase from March 31, 2012, but a \$1.8 million or 1.5% decrease from December 31, 2011. 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 of \$115.0 million during the three month period ended June 30, 2012 was 0.2% higher than the first quarter of 2012, but 8.8% higher than the prior year's second quarter. Most of the Company's growth in the past year 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, respectively, on the Company's balance sheet. The Better Checking product 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 \$2.4 million during the second quarter of 2012 and \$6.4 million during the first six months of the year. Overall NOW deposit growth was less as the Better Checking growth was offset by a decrease in municipal NOW accounts. Regular savings deposits increased \$9.0 million, or 2.7%, during the second quarter of 2012 and \$29.2 million, or 9.3% during the first six months of the year. That growth is mostly a result of an increase in Better Savings deposits, offset by decreases in legacy savings products. Growth in NOW and savings deposits slowed in the second quarter as the Company lowered rates on selected deposit products given the Company's current excess liquidity and declining net interest margin in this extended low rate environment.

Time deposits were \$108.3 million at June 30, 2012, a decrease of \$1.4 million, or 1.2%, from March 31, 2012, and a \$5.2 million, or 4.6%, decrease from December 31, 2011. Time deposit rates remain near historic lows. As a result, customers have continued to show a preference for liquid savings products over time deposits.

Other borrowings, which typically include the Bank's overnight line of credit and other advances with the FHLBNY, were \$19.0 million at June 30, 2012 compared with \$22.0 million at March 31, 2012 and December 31, 2011 as a \$3.0 million advance with FHLBNY matured and was not replaced. Because the Company's deposit growth has outpaced its loan growth this year, the Bank has not needed to add to its wholesale borrowings.

**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<br>June 30, 2012 |                             |                | Three Months Ended<br>June 30, 2011 |                             |                |
|--|-------------------------------------|-----------------------------|----------------|-------------------------------------|-----------------------------|----------------|
|  | Average<br>Outstanding<br>Balance   | Interest<br>Earned/<br>Paid | Yield/<br>Rate | Average<br>Outstanding<br>Balance   | Interest<br>Earned/<br>Paid | Yield/<br>Rate |
|  | (dollars in thousands)              |                             |                | (dollars in thousands)              |                             |                |
| <b>ASSETS</b>                                |                                     |                             |                |                                     |                             |                |
| Interest-earning assets:                     |                                     |                             |                |                                     |                             |                |
| Loans and leases, net                        | \$ 574,639                          | \$ 7,521                    | 5.24%          | \$ 524,178                          | \$ 7,081                    | 5.40%          |
| Taxable securities                           | 67,460                              | 457                         | 2.71%          | 61,069                              | 538                         | 3.52%          |
| Tax-exempt securities                        | 33,592                              | 296                         | 3.52%          | 39,570                              | 389                         | 3.93%          |
| Interest bearing deposits at banks           | 39,198                              | 15                          | 0.15%          | 16,952                              | 7                           | 0.17%          |
| <b>Total interest-earning assets</b>         | <b>714,889</b>                      | <b>8,289</b>                | <b>4.64%</b>   | <b>641,769</b>                      | <b>8,015</b>                | <b>5.00%</b>   |
| Non interest-earning assets:                 |                                     |                             |                |                                     |                             |                |
| Cash and due from banks                      | 11,509                              |                             |                | 16,523                              |                             |                |
| Premises and equipment, net                  | 10,442                              |                             |                | 10,612                              |                             |                |
| Other assets                                 | 36,311                              |                             |                | 35,382                              |                             |                |
| <b>Total Assets</b>                          | <b>\$ 773,151</b>                   |                             |                | <b>\$ 704,286</b>                   |                             |                |
| <b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b> |                                     |                             |                |                                     |                             |                |
| Interest-bearing liabilities:                |                                     |                             |                |                                     |                             |                |
| NOW  | \$ 60,472                           | \$ 150                      | 0.99%          | \$ 44,707                           | \$ 131                      | 1.17%          |
| Regular savings                              | 336,798                             | 483                         | 0.57%          | 268,220                             | 463                         | 0.69%          |
| Muni-Vest savings                            | 26,821                              | 21                          | 0.31%          | 29,483                              | 35                          | 0.47%          |
| Time deposits                                | 109,170                             | 492                         | 1.80%          | 139,727                             | 832                         | 2.38%          |
| Other borrowed funds                         | 20,645                              | 173                         | 3.35%          | 22,029                              | 182                         | 3.30%          |
| Junior subordinated debentures               | 11,330                              | 85                          | 3.00%          | 11,330                              | 82                          | 2.89%          |
| Securities sold U/A to repurchase            | 8,644                               | 4                           | 0.19%          | 6,022                               | 3                           | 0.20%          |
| <b>Total interest-bearing liabilities</b>    | <b>573,880</b>                      | <b>\$ 1,408</b>             | <b>0.98%</b>   | <b>521,518</b>                      | <b>\$ 1,728</b>             | <b>1.33%</b>   |
| Noninterest-bearing liabilities:             |                                     |                             |                |                                     |                             |                |
| Demand deposits                              | 115,033                             |                             |                | 105,725                             |                             |                |
| Other  | 12,472                              |                             |                | 11,144                              |                             |                |
| <b>Total liabilities</b>                     | <b>701,385</b>                      |                             |                | <b>\$ 638,387</b>                   |                             |                |
| Stockholders' equity                         | 71,766                              |                             |                | 65,899                              |                             |                |
| <b>Total Liabilities and Equity</b>          | <b>773,151</b>                      |                             |                | <b>\$ 704,286</b>                   |                             |                |
| <b>Net interest earnings</b>                 |                                     | <b>\$ 6,881</b>             |                |                                     | <b>\$ 6,287</b>             |                |

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|                      |       |       |
|----------------------|-------|-------|
| Net interest margin  | 3.85% | 3.92% |
| Interest rate spread | 3.66% | 3.67% |

**Table of Contents**

|   | Six Months Ended<br>June 30, 2012 |                             |                | Six Months Ended<br>June 30, 2011 |                             |                |
|---|-----------------------------------|-----------------------------|----------------|-----------------------------------|-----------------------------|----------------|
|   | Average<br>Outstanding<br>Balance | Interest<br>Earned/<br>Paid | Yield/<br>Rate | Average<br>Outstanding<br>Balance | Interest<br>Earned/<br>Paid | Yield/<br>Rate |
|   | (dollars in thousands)            |                             |                | (dollars in thousands)            |                             |                |
| <b>ASSETS</b>                                 |                                   |                             |                |                                   |                             |                |
| Interest-earning assets:                      |                                   |                             |                |                                   |                             |                |
| Loans and leases, net                         | \$ 571,735                        | \$ 15,029                   | 5.26%          | \$ 521,228                        | \$ 14,233                   | 5.46%          |
| Taxable securities                            | 69,184                            | 1,002                       | 2.90%          | 59,265                            | 1,024                       | 3.46%          |
| Tax-exempt securities                         | 34,003                            | 603                         | 3.55%          | 39,060                            | 760                         | 3.89%          |
| Interest bearing deposits at banks            | 31,252                            | 24                          | 0.15%          | 12,731                            | 11                          | 0.17%          |
| <b>Total interest-earning assets</b>          | <b>706,174</b>                    | <b>16,658</b>               | <b>4.72%</b>   | <b>632,284</b>                    | <b>16,028</b>               | <b>5.07%</b>   |
| Non interest-earning assets:                  |                                   |                             |                |                                   |                             |                |
| Cash and due from banks                       | 11,490                            |                             |                | 15,960                            |                             |                |
| Premises and equipment, net                   | 10,430                            |                             |                | 10,685                            |                             |                |
| Other assets                                  | 36,515                            |                             |                | 35,689                            |                             |                |
| <b>Total Assets</b>                           | <b>\$ 764,609</b>                 |                             |                | <b>\$ 694,618</b>                 |                             |                |
| <b>LIABILITIES &amp; STOCKHOLDERS' EQUITY</b> |                                   |                             |                |                                   |                             |                |
| Interest-bearing liabilities:                 |                                   |                             |                |                                   |                             |                |
| NOW   | \$ 57,791                         | \$ 290                      | 1.00%          | \$ 41,608                         | \$ 237                      | 1.14%          |
| Regular savings                               | 331,445                           | 1,048                       | 0.63%          | 262,226                           | 873                         | 0.67%          |
| Muni-Vest savings                             | 24,450                            | 41                          | 0.34%          | 27,072                            | 64                          | 0.47%          |
| Time deposits                                 | 110,625                           | 1,009                       | 1.82%          | 141,436                           | 1,708                       | 2.42%          |
| Other borrowed funds                          | 21,324                            | 354                         | 3.32%          | 24,594                            | 393                         | 3.20%          |
| Junior subordinated debentures                | 11,330                            | 173                         | 3.05%          | 11,330                            | 163                         | 2.88%          |
| Securities sold U/A to repurchase             | 8,910                             | 10                          | 0.22%          | 6,201                             | 7                           | 0.23%          |
| <b>Total interest-bearing liabilities</b>     | <b>565,875</b>                    | <b>\$ 2,925</b>             | <b>1.03%</b>   | <b>514,467</b>                    | <b>\$ 3,445</b>             | <b>1.34%</b>   |
| Noninterest-bearing liabilities:              |                                   |                             |                |                                   |                             |                |
| Demand deposits                               | 114,902                           |                             |                | 103,772                           |                             |                |
| Other   | 12,946                            |                             |                | 11,411                            |                             |                |
| <b>Total liabilities</b>                      | <b>693,723</b>                    |                             |                | <b>\$ 629,650</b>                 |                             |                |
| <b>Stockholders equity</b>                    | <b>70,886</b>                     |                             |                | <b>64,968</b>                     |                             |                |
| <b>Total Liabilities and Equity</b>           | <b>\$ 764,609</b>                 |                             |                | <b>\$ 694,618</b>                 |                             |                |
| <b>Net interest earnings</b>                  |                                   | <b>\$ 13,733</b>            |                |                                   | <b>\$ 12,583</b>            |                |
| <b>Net yield on interest earning assets</b>   |                                   |                             | <b>3.89%</b>   |                                   |                             | <b>3.98%</b>   |
| <b>Interest rate spread</b>                   |                                   |                             | <b>3.69%</b>   |                                   |                             | <b>3.73%</b>   |

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

Net income grew to \$1.5 million in the second quarter of 2012, up 54.0% from net income of \$1.0 million in the second quarter of 2011. The improvement in net income reflected a combination of higher net interest income, which resulted from growing interest earning assets, and a \$0.7 million year-over-year reduction in the provision for loan and lease losses due to the declining balance in the leasing portfolio and the improving credit quality trends in both the leasing and loan portfolios. The Company released \$0.2 million in leasing provision in the 2012 second quarter compared with no leasing provision for the prior-year period. Return on average equity was 8.34% for the second quarter of 2012 compared with 5.90% in the second quarter of 2011.

For the six months ended June 30, 2012, net income was \$3.9 million, or \$0.94 per diluted share, compared with net income of \$2.8 million, or \$0.69 per diluted share, in the same period in 2011. The return on average equity was 10.93% for the six-month period ended June 30, 2012, compared with 8.80% in the same period in 2011.

**Other Results of Operations Quarterly Comparison**

Net interest income was \$6.9 million for the 2012 second quarter, up 9.4% compared with the second quarter of 2011 and flat compared with the first quarter of 2012. Growth in interest-earning assets drove the increase from the second quarter of 2011 and offset the net interest margin contraction relative to the same period. Core loans, which are defined as total loans and leases less national direct financing leases, were \$594.6 million at June 30, 2012, an increase of 11.7% from \$532.5 million at June 30, 2011, and up 3.4% (13.5% annualized) from \$575.2 million at March 31, 2012. The majority of the loan growth in the second quarter of 2012 was in the commercial mortgage loan portfolios.

The Company's net interest margin decreased to 3.85% for the second quarter of 2012, down from 3.93% in the first quarter of 2012 and 3.92% in the second quarter of 2011. As compared to the second quarter 2011, the Company has been able to off-set the decrease in yield on interest-earning assets of 36 basis points by re-pricing its interest bearing liabilities, resulting in a reduction in the rate paid on interest-bearing liabilities of 35 basis points. The contribution of interest-free funds declined by 6 basis points when compared with the second quarter of 2011. As compared with the linked first quarter the decrease in the net interest margin is a result of a continuation of the declining interest rate environment. While the Company's loan and investment portfolios continue to re-price into lower yields, as evidenced by a decrease in yield on interest-earning assets of 16 basis points from the first quarter of 2012, the Company only benefited from re-pricing its interest-bearing liabilities during the second quarter of 2012 at a pace of 11 basis points.

The provision for loan and lease losses decreased to \$0.3 million in the second quarter of 2012 from a provision of \$1.0 million in the second quarter of 2011, and an increase from a release of provision of \$(0.2) million in the linked first quarter of 2012. The second quarter of 2012 benefitted from a release of \$0.2 million in leasing provision after continued improvement in the leasing portfolio's performance. This benefit was off-set by provision of \$0.3 million for the growth in loans in the second quarter of 2012 and the charge-off of an impaired commercial real estate loan that was \$0.2 million higher than its reserve at March 31, 2012.

Non-interest income, which represented 30.6% of total revenue in the second quarter of 2012, increased 3.9%, or \$0.1 million, to \$3.0 million when compared with the second quarter of 2011, reflecting positive performance for all categories. Service charges on deposits increased \$21 thousand, or 5.0%, compared with the second quarter 2011, primarily due to increases in fee rates to be more in-line with market competition. Insurance agency revenue of \$1.6 million was up \$42 thousand, or 2.6%, when compared with the 2011 second quarter due mostly to an increase in profit sharing revenue from the insurance carriers. The higher profit sharing was driven by the timing of payouts from insurance carriers; however, profit sharing trends are still down year over year as indicated in our year-to-date comparison below. Other income was up \$44 thousand from second quarter 2011 partly from higher merchant services fees due to a more beneficial contract with the Company's provider. Compared with the first quarter of 2012, total non-interest income was down \$0.2 million due mainly to TEA's decrease in revenue of \$0.3 million, reflecting the typical revenue cycle seasonality.

Total non-interest expense was \$7.3 million in the second quarter of 2012, an increase of \$0.6 million, or 8.3%, from \$6.8 million in the second quarter of 2011. The largest component of the increase was salaries and employee benefits, which was up \$0.3 million, or 8.1%, to \$4.2 million compared with the second quarter of 2011. This rise

**Table of Contents**

reflected merit increases awarded for 2011 performance, higher health care costs and increased staff levels. Additionally, advertising expense was higher by \$89 thousand in the second quarter of 2012 from the prior year second quarter as the Company looked to capitalize on disruption in the marketplace from the HSBC sale of its Western New York branch network. Professional services expense also increased during the quarter due mainly to higher legal expenses, particularly those related to resolving and collecting impaired loans. These increases were partially offset by lower occupancy costs, mostly related to fully depreciated assets lowering depreciation expense.

As a result of the increase in non-interest expense, the efficiency ratio increased to 72.76% for the second quarter of 2012 from 72.04% for the second quarter of 2011.

Income tax expense for the quarter ended June 30, 2012, was \$0.8 million, representing an effective tax rate of 34.9% compared with an effective tax rate of 32.6% in the second quarter of 2011. The effective tax rate increased as tax-exempt income such as interest income from municipal bonds and the increase in the cash surrender value of bank-owned life insurance made up a smaller percentage of total income.

**Other Results of Operations Year-to-Date Comparison**

Net interest income was \$13.7 million for the six months ended June 30, 2012, a 9.1% increase from the first six months of 2011. Growth in interest-earning assets, particularly loans, drove the increase from 2011 and offset the net interest margin contraction relative to the same period.

The Company's net interest margin decreased to 3.89% for the six month period ended June 30, 2012, down from 3.98% in the first six months of 2011. As the low interest rate cycle continues, the Company's loan and investment portfolios re-price into lower yields as evidenced by a decrease in yield on interest-earning assets of 35 basis points in the first six months of 2012 when compared with the same period in 2011. The Company benefited from re-pricing its interest-bearing liabilities earlier in the interest rate cycle so these rates have fallen less than the yield on interest-earning assets in the past year. Correspondingly, the cost of interest-bearing liabilities for the first six months of 2012 declined only 31 basis points when compared with the same period in 2011.

The provision for loan and lease losses decreased to \$0.1 million in the six month period ended June 30, 2012 from a provision of \$1.5 million in the six month period ended June 30, 2011. With the continuing improvement in the performance of the leasing portfolio including a steep decrease in non-performing leases, the Company released \$0.6 million in leasing reserves in the first six month of 2012 compared with a provision for lease losses of zero in the first six months of 2011. The provision for loan losses (not including leases) decreased from \$1.5 million in the six month period ended June 30, 2011 to \$0.7 million in the first six months of 2012. In the prior year period there was deterioration in several commercial loan relationships that drove the higher provision. In contrast, in 2012, non-performing loans and leases as a percentage of total loans and leases has decreased from 2.60% at December 31, 2011 to 1.84% at June 30, 2012.

Non-interest income, which represented 31.5% of total revenue in the first six months of 2012, decreased 0.9%, or \$0.1 million, to \$6.3 million when compared with the first six months of 2011. Data center income, which declined \$0.2 million from the prior year's first six months, is from the Bank's wholly-owned subsidiary, Suchak Data Systems, LLC (SDS). SDS is a data processing company which was acquired by the Bank on December 31, 2008. The original contracted revenue generated by service agreements with other banks is expiring as expected. The Company is focusing on the original purpose for the purchase of SDS, which was to provide resources for its own internal bank processing needs. Insurance agency revenue of \$3.6 million for the six month period ended June 30, 2012 was down \$0.1 million, or 2.7%, when compared with the six month period ended June 30, 2011 due mostly to a decrease in profit sharing revenue from the insurance carriers. The lower profit sharing is driven by higher loss ratios related to lower premium levels. These negative trends were somewhat offset by increased deposit service charges, premiums on loans sold, bank-owned life insurance (BOLI) income and other income. Deposit service charges increased \$71 thousand, or 8.9%, compared with the first six months of 2011, primarily due to increases in fee rates to be more in-line with market competition. Premiums on loans sold increased \$56 thousand year over year due to more disciplined pricing and improved execution on loan sales to FNMA. BOLI income increased \$39 thousand, or 18.3%, due to an increased investment in BOLI, which increased from \$12.6 million at June 30, 2011 to \$15.1 million at June 30, 2012. Other income was up \$63 thousand in the first six months of 2012 when compared to the prior year mostly from higher merchant services fees due to a more beneficial contract with the Company's provider.

**Table of Contents**

Total non-interest expense was \$14.2 million in the six month period ended June 30, 2012, an increase of \$0.9 million, or 6.5%, from \$13.4 million in the second quarter of 2011. The largest component of the increase was salaries and employee benefits, which was up \$0.6 million, or 8.0%, from the first six months of 2011 to \$8.4 million in the first six months of 2012. This rise primarily reflected merit increases awarded for 2011 performance, higher health care costs and increased staff levels. Additionally, advertising expense was higher by \$0.1 million in the six month period ended June 30, 2012 from the prior year as the Company looked to capitalize on disruption in the marketplace from the HSBC sale of its Western New York branch network. Professional services expenses increased \$0.3 million from \$0.8 million in the six month period ended June 30, 2011 to \$1.1 million in the first six months of 2012. The increase is due mainly to higher legal expenses, particularly those related to resolving and collecting impaired loans. These increases were partially offset by occupancy costs of \$1.3 million, which were \$0.3 million lower in the first six months of 2012 when compared with 2011, mostly related to fully depreciated assets lowering depreciation expense.

As a result of the increase in non-interest expense, the efficiency ratio increased to 69.90% for the six month period ended June 30, 2012 from 69.11% in the corresponding period in 2011.

Income tax expense for the six months ended June 30, 2012, was \$1.9 million, representing an effective tax rate of 32.9% compared with an effective tax rate of 30.7% in the six month period ended June 30, 2011. The effective tax rate increased as tax-exempt income such as interest income from municipal bonds and the increase in the cash surrender value of bank-owned life insurance was a smaller percentage of total income.

**CAPITAL**

The Company consistently maintains regulatory capital ratios measurably above the federal well capitalized standard, including a Tier 1 leverage ratio of 9.77% at June 30, 2012 and 9.71% at December 31, 2011. Book value per share of the Company's common stock was \$17.40 at June 30, 2012, compared with \$16.72 at December 31, 2011. Tangible book value per share at June 30, 2012 was \$15.34, compared with \$14.60 at December 31, 2011. The increase in both book value and tangible book value per share is a result of the Company's \$3.9 million in net income, somewhat offset by the dividend paid in the second quarter of 2012.

On February 21, 2012, the Company declared a semi-annual cash dividend of \$0.22 per share on the Company's outstanding common stock. The dividend was paid on April 10, 2012 to shareholders of record as of March 20, 2012. The dividend was a 10% increase from the previous semi-annual dividend of \$0.20 paid on October 4, 2011.

**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 \$129.5 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. The Company has accessed the capital markets as recently as May 2010 when it raised \$13.4 million in net proceeds in connection with its registered offering and sale of 1.2 million shares of common stock.

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 June 30, 2012, approximately 4.9% of the Bank's securities had contractual maturity dates of one year or less and approximately 23.0% 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



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**Table of Contents**

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 June 30, 2012, in the Company's internal stress test, the Company had net short-term liquidity of \$75.0 million as compared with \$82.6 million at December 31, 2011. Available assets of \$131.0 million, divided by public and purchased funds of \$118.5 million, resulted in a long-term liquidity ratio of 111% at June 30, 2012, compared with 99% at December 31, 2011.

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.

**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**

**Table of Contents**

|                                  | <b>Calculated increase<br/>in projected annual net interest income</b><br>(in thousands) |                              |
|----------------------------------|--|------------------------------|
|                                  | <b>June 30,<br/>2012</b>   | <b>December<br/>31, 2011</b> |
| <b>Changes in interest rates</b> |  |                              |
| +200 basis points                | (\$121)  | \$ 1,126                     |
| +100 basis points                | 657  | 1,452                        |
| -100 basis points                | N/A  | NM                           |
| -200 basis points                | N/A  | NM                           |

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 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 June 30, 2012 (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 June 30, 2012 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 June 30, 2012 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.

DATE August 3, 2012

Evans Bancorp, Inc.

/s/ David J. Nasca  
David J. Nasca  
President and CEO

(Principal Executive Officer)

DATE August 3, 2012

/s/ Gary A. Kajtoch  
Gary A. Kajtoch  
Treasurer

(Principal Financial Officer)

**Table of Contents****EXHIBIT INDEX**

| Exhibit No. | Name   | Page No. |
|-------------|--|----------|
| 10.1*       | Evans Bancorp, Inc. Executive Severance Plan (incorporated by reference to the Company's Current Report on Form 8-K filed on May 23, 2012).  |          |
| 31.1        | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  | 54       |
| 31.2        | Certification of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  | 55       |
| 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.   | 56       |
| 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.   | 57       |
| 101         | The following materials from Evans Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Unaudited Consolidated Balance Sheets June 30, 2012 and December 31, 2011; (ii) Unaudited Consolidated Statements of Income Three months ended June 30, 2012 and 2011; (iii) Unaudited Consolidated Statements of Income Six months ended June 30, 2012 and 2011; (iv) Unaudited Statements of Consolidated Comprehensive Income Three months ended June 30, 2012 and 2011; (v) Unaudited Statements of Consolidated Comprehensive Income Six months ended June 30, 2012 and 2011; (vi) Unaudited Consolidated Statements of Stockholder's Equity Six months ended June 30, 2012 and 2011; (vii) Unaudited Consolidated Statements of Cash Flows Six months ended June 30, 2012 and 2011; and (vi) Notes to Unaudited Consolidated Financial Statements.** |          |

\* Indicates a management contract or compensatory plan or arrangement.

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