BAR HARBOR BANKSHARES
Form 10-Q
August 09, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

# FORM 10-Q

(Mark One)

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

**For the quarterly period ended June 30, 2012**

**OR**

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

Commission File Number: **01-13349**

**BAR HARBOR BANKSHARES**

(Exact name of registrant as specified in its charter)

| **Maine** | **01-0393663** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |
| **PO Box 400**<br>**82 Main Street, Bar Harbor, ME** | **04609-0400** |
| (Address of principal executive offices) | (Zip Code) |

**(207) 288-3314**

(Registrant's telephone number, including area code)

**Inapplicable**

(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 **þ** 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 **þ** 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: Large accelerated filer ¨ Accelerated filer **þ** Non-accelerated filer (do not check if a 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: **þ**

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

| Class of Common Stock | Number of Shares Outstanding August 02, 2012 |
|---|---|
| **$2.00 Par Value** | **3,911,265** |

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**PART I. FINANCIAL INFORMATION**

**Item 1. FINANCIAL STATEMENTS**

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**JUNE 30, 2012 AND DECEMBER 31, 2011**

**(Dollars in thousands, except share and per share data)**

(*unaudited*)

| | **June 30, 2012** | **December 31, 2011** |
|---|---|---|
| Assets | | |
| Cash and cash equivalents | 9,891 | 8,720 |
| Securities available for sale, at fair value | 404,844 | 381,880 |
| Federal Home Loan Bank stock | 17,429 | 16,068 |
| Loans | 776,931 | 729,003 |
| Allowance for loan losses | (8,354) | (8,221) |
| Loans, net of allowance for loan losses | 768,577 | 720,782 |
| Premises and equipment, net | 18,107 | 16,090 |
| Goodwill | 3,158 | 3,158 |
| Bank owned life insurance | 7,513 | 7,377 |
| Other assets | 12,722 | 13,391 |
| TOTAL ASSETS | $1,242,241 | $1,167,466 |
| | | |
| Liabilities | | |
| Deposits: | | |
| Demand and other non-interest bearing deposits | $ 62,090 | $ 62,648 |
| NOW accounts | 98,713 | 99,120 |
| Savings and money market deposits | 201,538 | 206,704 |
| Time deposits | 374,755 | 354,418 |
| Total deposits | 737,096 | 722,890 |
| Short-term borrowings | 218,690 | 175,813 |
| Long-term advances from Federal Home Loan Bank | 150,990 | 139,470 |
| Junior subordinated debentures | 5,000 | 5,000 |
| Other liabilities | 5,911 | 6,043 |
| TOTAL LIABILITIES | 1,117,687 | 1,049,216 |
| | | |
| Shareholders' equity | | |
| Capital stock, par value $2.00; authorized 10,000,000 shares; | | |
| issued 4,525,635 shares at June 30, 2012 and December 31, 2011 | 9,051 | 9,051 |

| | | |
|---|---|---|
| Surplus | 26,594 | 26,512 |
| Retained earnings | 90,120 | 86,198 |
| Accumulated other comprehensive income: | | |
| Prior service cost and unamortized net actuarial losses on employee benefit plans, net of tax of ($8) and ($9), at June 30, 2012 and December 31, 2011, respectively | (16) | (17) |
| Net unrealized appreciation on securities available for sale, net of tax of $4,375 and $3,845, at June 30, 2012 and December 31, 2011, respectively | 8,492 | 7,464 |
| Portion of OTTI attributable to non-credit losses, net of tax of $62 and ($218), at June 30, 2012, and December 31, 2011, respectively | 119 | (423) |
| Total accumulated other comprehensive income | 8,595 | 7,024 |
| Less: cost of 619,561 and 646,742 shares of treasury stock at June 30, 2012 and December 31, 2011, respectively | (9,806) | (10,535) |
| TOTAL SHAREHOLDERS' EQUITY | 124,554 | 118,250 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $1,242,241 | $1,167,466 |

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements.*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2012 AND 2011**

**(Dollars in thousands, except per share data)**

*(unaudited)*

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Interest and dividend income: | | | | |
| Interest and fees on loans | $ 8,855 | $ 8,823 | $17,733 | $17,304 |
| Interest on securities | 3,542 | 4,081 | 7,231 | 8,266 |
| Dividend on FHLB stock | 21 | 12 | 41 | 24 |
| Total interest and dividend income | 12,418 | 12,916 | 25,005 | 25,594 |
| Interest expense: | | | | |
| Deposits | 1,899 | 2,190 | 3,854 | 4,404 |
| Short-term borrowings | 119 | 66 | 214 | 144 |
| Long-term debt | 1,447 | 2,036 | 2,967 | 4,088 |
| Total interest expense | 3,465 | 4,292 | 7,035 | 8,636 |
| Net interest income | 8,953 | 8,624 | 17,970 | 16,958 |
| Provision for loan losses | 460 | 600 | 875 | 1,100 |
| Net interest income after provision for loan losses | 8,493 | 8,024 | 17,095 | 15,858 |
| Non-interest income: | | | | |
| Trust and other financial services | 839 | 736 | 1,618 | 1,515 |
| Service charges on deposit accounts | 286 | 336 | 536 | 625 |
| Credit and debit card service charges and fees | 340 | 291 | 656 | 579 |
| Net securities gains | 670 | 535 | 1,237 | 1,320 |
| Total other-than-temporary impairment ("OTTI") losses | (376) | (589) | (834) | (1,154) |
| Non-credit portion of OTTI losses (before taxes) (1) | 40 | --- | 154 | --- |
| Net OTTI losses recognized in earnings | (336) | (589) | (680) | (1,154) |
| Other operating income | 175 | 176 | 307 | 332 |
| Total non-interest income | 1,974 | 1,485 | 3,674 | 3,217 |
| Non-interest expense: | | | | |
| Salaries and employee benefits | 3,309 | 2,959 | 6,491 | 6,067 |
| Occupancy expense | 370 | 372 | 775 | 803 |
| Furniture and equipment expense | 492 | 427 | 907 | 845 |
| Credit and debit card expenses | 87 | 73 | 175 | 145 |
| FDIC insurance assessments | 187 | 364 | 372 | 628 |
| Other operating expense | 1,712 | 1,567 | 3,245 | 2,809 |
| Total non-interest expense | 6,157 | 5,762 | 11,965 | 11,297 |

| | | | | |
|---|---|---|---|---|
| Income before income taxes | 4,310 | 3,747 | 8,804 | 7,778 |
| Income taxes | 1,205 | 974 | 2,536 | 2,136 |
| Net income | $ 3,105 | $ 2,773 | $ 6,268 | $ 5,642 |
| **Per Common Share Data:** | | | | |
| Basic earnings per share | $ 0.80 | $ 0.72 | $ 1.61 | $ 1.47 |
| Diluted earnings per share | $ 0.79 | $ 0.72 | $ 1.61 | $ 1.46 |

*(1) Included in other comprehensive loss, net of tax*

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements.*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2012 AND 2011**

**(Dollars in thousands)**

*(unaudited)*

| | Three Months Ended | |
|---|---|---|
| | June 30, | |
| | 2012 | 2011 |
| Net income | $ 3,105 | $ 2,773 |
| Other comprehensive income: | | |
| Net unrealized appreciation on securities available for sale, | | |
| net of tax of $683 and $1,928, respectively | 1,326 | 3,738 |
| Less reclassification adjustment for net gains related to securities | | |
| available for sale included in net income, | | |
| net of tax of ($228) and ($182), respectively | (442) | (353) |
| Add other-than-temporary impairment adjustment, | | |
| net of tax of ($128) and $199, respectively | 248 | 390 |
| Less non-credit portion of other-than-temporary impairment losses, | | |
| net of tax of ($13), and $0, respectively | (27) | --- |
| Amortization of actuarial gain for supplemental executive retirement plan, | | |
| net of related tax of $1 and $0, respectively | 1 | 1 |
| Total other comprehensive income | 1,106 | 3,776 |
| Total comprehensive income | $ 4,211 | $ 6,549 |

| | Six Months Ended | |
|---|---|---|
| | June 30, | |
| | 2012 | 2011 |
| Net income | $ 6,268 | $5,642 |
| Other comprehensive income: | | |
| Net unrealized appreciation on securities available for sale, | | |
| net of tax of $998 and $1,554, respectively | 1,938 | 3,014 |
| Less reclassification adjustment for net gains related to securities | (816) | (871) |

| | | |
|---|---|---|
| available for sale included in net income, | | |
| net of tax of ($421) and ($449), respectively | | |
| Add other-than-temporary impairment adjustment, | | |
| net of tax of $284 and $392, respectively | 550 | 762 |
| Less non-credit portion of other-than-temporary impairment losses, | | |
| net of tax of ($52), and $0, respectively | (102) | --- |
| Amortization of actuarial gain for supplemental executive retirement plan, | | |
| net of related tax of $1 and $1, respectively | 1 | 1 |
| Total other comprehensive income | 1,571 | 2,906 |
| Total comprehensive income | $ 7,839 | $8,548 |

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

**FOR THE SIX MONTHS ENDED JUNE 30, 2012 AND 2011**

**(Dollars in thousands, except share and per share data)**

*(unaudited)*

| | Capital Stock | Surplus | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| **Balance December 31, 2010** | $ 9,051 | $26,165 | $80,379 | $ 284 | $(12,271) | $103,608 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Net income | --- | --- | 5,642 | --- | --- | 5,642 |
| Total other comprehensive income | --- | --- | --- | 2,906 | --- | 2,906 |
| Dividend declared: | | | | | | |
| Common stock ($0.54 per share) | --- | --- | (2,074) | --- | --- | (2,074) |
| Purchase of treasury stock (4,220 shares) | --- | --- | --- | --- | (119) | (119) |
| Stock options exercised (44,768 shares), including related tax effects | --- | 146 | (568) | --- | 1,340 | 918 |
| Recognition of stock based compensation expense | --- | 49 | --- | --- | --- | 49 |
| **Balance June 30, 2011** | $9,051 | $26,360 | $83,379 | $3,190 | $(11,050) | $110,930 |

| | **Capital Stock** | **Surplus** | **Retained Earnings** | **Accumulated Other Comprehensive Income** | **Treasury Stock** | **Total Shareholders' Equity** |
|---|---|---|---|---|---|---|
| **Balance December 31, 2011** | $ 9,051 | $26,512 | $86,198 | $7,024 | $(10,535) | $118,250 |
| Net income | --- | --- | 6,268 | --- | --- | 6,268 |
| Total other comprehensive income | --- | --- | --- | 1,571 | --- | 1,571 |
| Dividend declared: | | | | | | |
| Common stock ($0.575 per share) | --- | --- | (2,234) | --- | --- | (2,234) |
| Stock options exercised (27,181 shares), including related tax effects | --- | 22 | (140) | --- | 688 | 570 |
| Recognition of stock based compensation expense | --- | 109 | 20 | --- | --- | 129 |
| Restricted stock grants | --- | (49) | 8 | --- | 41 | --- |
| **Balance June 30, 2012** | $ 9,051 | $26,594 | $90,120 | $8,595 | $ (9,806) | $124,554 |

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements.*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE SIX MONTHS ENDED JUNE 30, 2012 AND 2011**

**(Dollars in thousands)**

*(unaudited)*

| | **2012** | **2011** |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 6,268 | $ 5,642 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of premises and equipment | 597 | 602 |
| Provision for loan losses | 875 | 1,100 |
| Net securities gains | (1,237) | (1,320) |
| Other-than-temporary impairment | 680 | 1,154 |
| Net amortization of bond premiums and discounts | 1,682 | 678 |
| Recognition of stock based expense | 129 | 49 |
| Net change in other assets | (105) | (1,204) |
| Net change in other liabilities | (132) | (414) |
| Net cash provided by operating activities | 8,757 | 6,287 |
| | | |
| Cash flows from investing activities: | | |
| Purchases of securities available for sale | (88,785) | (63,608) |
| Proceeds from maturities, calls and principal paydowns of mortgage-backed securities | 42,840 | 36,328 |
| Proceeds from sales of securities available for sale | 24,233 | 22,473 |
| Purchase of FHLB stock | (1,361) | --- |
| Net loans made to customers | (49,194) | (31,481) |
| Proceeds from sale of other real estate owned | 356 | --- |
| Capital expenditures | (2,614) | (1,186) |
| Net cash used in investing activities | (74,525) | (37,474) |
| | | |
| Cash flows from financing activities: | | |
| Net increase in deposits | 14,206 | 20,787 |
| Net decrease in securities sold under repurchase agreements and fed funds purchased | (5,918) | (17,386) |
| Proceeds from Federal Home Loan Bank advances | 84,500 | 44,000 |
| Repayments of Federal Home Loan Bank advances | (24,185) | (19,032) |
| Purchase of treasury stock | --- | (119) |
| Proceeds from stock option exercises, including excess tax benefits | 570 | 918 |
| Payments of dividends | (2,234) | (2,074) |
| Net cash provided by financing activities | 66,939 | 27,094 |
| | | |
| Net increase (decrease) in cash and cash equivalents | 1,171 | (4,093) |
| Cash and cash equivalents at beginning of period | 8,720 | 12,815 |

| | | |
|---|---|---|
| Cash and cash equivalents at end of period | $ 9,891 | $ 8,722 |
| | | |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | $ 7,088 | $ 8,749 |
| Income taxes | 1,573 | 1,944 |
| | | |
| Schedule of noncash investing activities: | | |
| Transfers from loans to other real estate owned | $ 524 | $ 794 |

*The accompanying notes are an integral part of these unaudited consolidated interim financial statements.*

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**JUNE 30, 2012**

**(Dollars in thousands, except share data)**

(*unaudited*)

**Note 1: Basis of Presentation**

The accompanying consolidated interim financial statements are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All inter-company transactions have been eliminated in consolidation. Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation. The net income reported for the three and six months ended June 30, 2012, is not necessarily indicative of the results that may be expected for the year ending December 31, 2012, or any other interim periods.

The consolidated balance sheet at December 31, 2011, has been derived from audited consolidated financial statements at that date. The accompanying unaudited interim consolidated financial statements have been prepared in accordance with United States ( U.S. ) generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X (17 CFR Part 210). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, please refer to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011, and notes thereto.

**Note 2: Management s Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, other-than-temporary impairments on securities, income tax estimates, and the valuation of intangible assets.

***Allowance for Loan Losses:*** The allowance for loan losses (the allowance ) is a significant accounting estimate used in the preparation of the Company s consolidated financial statements. The allowance is available to absorb losses on loans and is maintained at a level that, in management s judgment, is appropriate for the amount of risk inherent in the loan portfolio, given past and present conditions. The allowance is increased by provisions charged to operating expense and by recoveries on loans previously charged-off, and is decreased by loans charged-off as uncollectible.

Arriving at an appropriate level of allowance involves a high degree of judgment. The determination of the adequacy of the allowance and provisioning for estimated losses is evaluated regularly based on review of loans, with particular emphasis on non-performing or other loans that management believes warrant special consideration. The ongoing evaluation process includes a formal analysis, which considers among other factors: the character and size of the loan portfolio, business and economic conditions, real estate market conditions, collateral values, changes in product offerings or loan terms, changes in underwriting and/or collection policies, loan growth, previous charge-off experience, delinquency trends, non-performing loan trends, the performance of individual loans in relation to contract terms, and estimated fair values of collateral.

The allowance consists of allowances established for specific loans including impaired loans; allowances for pools of loans based on historical charge-offs by loan types; and supplemental allowances that adjust historical loss experience to reflect current economic conditions, industry specific risks, and other observable data.

While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers may necessitate future additions or reductions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the allowance, which also may necessitate future additions or reductions to the allowance, based on information available to them at the time of their examination.

***Other-Than-Temporary Impairments on Investment Securities*****:** One of the significant estimates relating to securities is the evaluation of other-than-temporary impairment. If a decline in the fair value of a security is judged to be other-than-temporary, and management does not intend to sell the security and believes it is more-likely-than-not the Company will not be required to sell the security prior to recovery of cost or amortized cost, the portion of the total impairment attributable to the credit loss is recognized in earnings, and the remaining difference between the security s amortized cost basis and its fair value is included in other comprehensive income.

For impaired available for sale debt securities that management intends to sell, or where management believes it is more-likely-than-not that the Company will be required to sell, an other-than-temporary impairment charge is recognized in earnings equal to the difference between fair value and cost or amortized cost basis of the security. The fair value of the other-than-temporarily impaired security becomes its new cost basis.

The evaluation of securities for impairments is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of securities should be recognized in

current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer s financial condition and/or future prospects, the effects of changes in interest rates or credit spreads and the expected recovery period of unrealized losses. The Company has a security monitoring process that identifies securities that, due to certain characteristics, as described below, are subjected to an enhanced analysis on a quarterly basis.

Securities that are in an unrealized loss position, are reviewed at least quarterly to determine if an other-than-temporary impairment is present based on certain quantitative and qualitative factors and measures. The primary factors considered in evaluating whether a decline in value of securities is other-than-temporary include: (a) the cause of the impairment; (b) the financial condition, credit rating and future prospects of the issuer; (c) whether the debtor is current on contractually obligated interest and principal payments; (d) the volatility of the securities fair value; (e) performance indicators of the underlying assets in the security including default rates, delinquency rates, percentage of non-performing assets, loan to collateral value ratios, conditional payment rates, third party guarantees, current levels of subordination, vintage, and geographic concentration and; (f) any other information and observable data considered relevant in determining whether other-than-temporary impairment has occurred, including the expectation of the receipt of all principal and interest due.

In addition, for securitized financial assets with contractual cash flows, such as private label mortgage-backed securities, the Company periodically updates its best estimate of cash flows over the life of the security. The Company s best estimate of cash flows is based upon assumptions consistent with the current economic environment, similar to those the Company believes market participants would use. If the fair value of a securitized financial asset is less than its cost or amortized cost and there has been an adverse change in timing or amount of anticipated future cash flows since the last revised estimate to the extent that the Company does not expect to receive the entire amount of future contractual principal and interest, an other-than-temporary impairment charge is recognized in earnings representing the estimated credit loss if management does not intend to sell the security and believes it is more-likely-than-not the Company will not be required to sell the security prior to recovery of cost or amortized cost. Estimating future cash flows is a quantitative and qualitative process that incorporates information received from third party sources along with certain assumptions and judgments regarding the future performance of the underlying collateral. In addition, projections of expected future cash flows may change based upon new information regarding the performance of the underlying collateral.

***Income Taxes:*** The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. If current available information indicates that it is more-likely-than-not that deferred tax assets will not be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Significant management judgment is required in determining income tax expense and deferred tax assets and liabilities. As of June 30, 2012 and December 31, 2011, there was no valuation allowance for deferred tax assets. Deferred tax assets are included in other assets on the consolidated balance sheet.

***Goodwill and Identifiable Intangible Assets:*** In connection with acquisitions, the Company generally records as assets on its consolidated financial statements both goodwill and identifiable intangible assets, such as core deposit

intangibles.

The Company evaluates whether the carrying value of its goodwill has become impaired, in which case the value is reduced through a charge to its earnings. Goodwill is evaluated for impairment at least annually, or upon a triggering event using certain fair value techniques. Goodwill impairment testing is performed at the segment (or reporting unit ) level. Goodwill is assigned to reporting units at the date the goodwill is initially recorded. Once goodwill has been assigned to the reporting units, it no longer retains its association with a particular acquisition, and all of the activities within a reporting unit, whether acquired or organically grown, are available to support the value of the goodwill.

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. The Company completes its annual goodwill impairment test as of December 31 of each year. The impairment testing process is conducted by assigning assets and goodwill to each reporting unit. Currently, the Company s goodwill is evaluated at the entity level as there is only one reporting unit. The Company first assesses certain qualitative factors to determine if it is more likely than not that the fair value of the reporting unit is less than its carrying value. If it is more likely than not that the fair value of the reporting unit is less than the carrying value, then the fair value of each reporting unit is compared to the recorded book value step one. If the fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and step two is not considered necessary. If the carrying value of a reporting unit exceeds its fair value, the impairment test continues ( step two ) by comparing the carrying value of the reporting unit s goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill. An impairment charge is recognized if the carrying fair value of goodwill exceeds the implied fair value of goodwill. At December 31, 2011, there was no indication of impairment that led the Company to believe it needed to perform a two-step test.

At June 30, 2012 and December 31, 2011, the Company did not have any identifiable intangible assets on its consolidated balance sheet.

Any changes in the estimates used by the Company to determine the carrying value of its goodwill, or which otherwise adversely affect their value or estimated lives, would adversely affect the Company s consolidated results of operations.

**Note 3: Earnings Per Share**

Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company, such as the Company s dilutive stock options.

The following is a reconciliation of basic and diluted earnings per share for the three and six months ended June 30, 2012 and 2011:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2012** | **2011** | **2012** | **2011** |
| Net income | $ 3,105 | $ 2,773 | $ 6,268 | $ 5,642 |
| Weighted average common shares outstanding | | | | |
| Basic | 3,891,476 | 3,852,455 | 3,885,764 | 3,841,025 |
| Effect of dilutive employee stock options | 27,376 | 20,953 | 18,763 | 25,538 |
| Diluted | 3,918,852 | 3,873,408 | 3,904,527 | 3,866,563 |
| Anti-dilutive options excluded from earnings per share calculation | 9,000 | 131,659 | 14,000 | 131,659 |
| **Per Common Share Data:** | | | | |
| Basic earnings per share | $ 0.80 | $ 0.72 | $ 1.61 | $ 1.47 |
| Diluted earnings per share | $ 0.79 | $ 0.72 | $ 1.61 | $ 1.46 |

**Note 4: Securities Available For Sale**

The following tables summarize the securities available for sale portfolio as of June 30, 2012 and December 31, 2011:

| **June 30, 2012** | | **Gross** | **Gross** | |
|---|---|---|---|---|
| | **Amortized** | **Unrealized** | **Unrealized** | **Estimated** |
| **Available for Sale:** | **Cost** | **Gains** | **Losses** | **Fair Value** |
| Obligations of US Government sponsored enterprises | $ 1,000 | $ 12 | $ --- | $ 1,012 |
| Mortgage-backed securities: | | | | |
| US Government-sponsored enterprises | 224,893 | 8,818 | 133 | 233,578 |
| US Government agency | 81,692 | 3,223 | 17 | 84,898 |
| Private label | 9,861 | 519 | 726 | 9,654 |
| Obligations of states and political subdivisions thereof | 74,351 | 2,741 | 1,390 | 75,702 |
| Total | $391,797 | $ 15,313 | $2,266 | $404,844 |

| **December 31, 2011** | | **Gross** | **Gross** | |
|---|---|---|---|---|
| | **Amortized** | **Unrealized** | **Unrealized** | **Estimated** |
| **Available for Sale:** | **Cost** | **Gains** | **Losses** | **Fair Value** |
| Obligations of US Government sponsored enterprises | $ 1,000 | $ 23 | $ --- | $ 1,023 |
| Mortgage-backed securities: | | | | |
| US Government-sponsored enterprises | 225,962 | 9,414 | 127 | 235,249 |
| US Government agency | 72,585 | 2,932 | 23 | 75,494 |
| Private label | 13,504 | 201 | 1,492 | 12,213 |
| Obligations of states and political subdivisions thereof | 58,160 | 2,199 | 2,458 | 57,901 |
| Total | $371,211 | $14,769 | $ 4,100 | $381,880 |

***Securities Maturity Distribution:*** The following table summarizes the maturity distribution of the amortized cost and estimated fair value of securities available for sale as of June 30, 2012. Actual maturities may differ from the final maturities noted below because issuers may have the right to prepay or call certain securities. In the case of mortgage-backed securities, actual maturities may also differ from expected maturities due to the amortizing nature of the underlying mortgage collateral, and the fact that borrowers have the right to prepay.

| **Securities Available for Sale** | **Amortized** | **Estimated** |
|---|---|---|

| | Cost | Fair Value |
|---|---|---|
| Due one year or less | $ 1,085 | $ 1,098 |
| Due after one year through five years | 1,351 | 1,308 |
| Due after five years through ten years | 23,482 | 24,664 |
| Due after ten years | 365,879 | 377,774 |
| | $391,797 | $404,844 |

***Securities Impairment:*** As a part of the Company s ongoing security monitoring process, the Company identifies securities in an unrealized loss position that could potentially be other-than-temporarily impaired ( OTTI ).

For the three and six months ended June 30, 2012, the Company recorded total OTTI losses of $376 and $834 in the statement of income (before taxes), related to ten, available for sale, private-label mortgage-backed securities ( MBS ), all of which the Company had previously determined were other-than-temporarily impaired. Of the $834 in total year-to-date OTTI losses, $680 (before taxes) represented estimated credit losses on the collateral underlying the securities, while $154 (before taxes) represented unrealized losses for the same securities resulting from factors other than credit. The $680 in estimated credit losses were recorded in earnings (before taxes), with the $154 non-credit portion of the unrealized losses recorded within accumulated other comprehensive income. The additional credit losses principally reflected an increase in the future loss severity and constant default rate estimates resulting from depressed and still declining real estate markets, extended foreclosure and collateral liquidation timelines, and depressed economic conditions that affected the expected performance of the mortgage loans underlying these securities.

The OTTI losses recognized in earnings during the three and six months ended June, 2012 represented management s best estimate of credit losses inherent in the securities based on discounted, bond-specific future cash flow projections using assumptions about cash flows associated with the pools of mortgage loans underlying each security. In estimating those cash flows the Company takes a variety of factors into consideration including, but not limited to, loan level credit characteristics, current delinquency and non-performing loan rates, current levels of subordination and credit support, recent default rates and future constant default rate estimates, original and current loan to collateral value ratios, recent collateral loss severities and future collateral loss severity estimates, recent and historical conditional prepayment rates and future conditional prepayment rate assumptions, and other estimates of future collateral performance.

Despite some rising levels of delinquencies, defaults and losses in the underlying residential mortgage loan collateral, given credit enhancements resulting from the structures of the individual securities, the Company currently expects that as of June 30, 2012 it will recover the amortized cost basis of its private label mortgage-backed securities as depicted in the table below and has therefore concluded that such securities were not other-than-temporarily impaired as of that date. Nevertheless, given recent market conditions, it is possible that adverse changes in repayment performance and fair value could occur in future periods that could impact the Company s current best estimates.

The following table displays the beginning balance of OTTI related to historical credit losses on debt securities held by the Company at the beginning of the current reporting period, as well as changes in credit losses recognized in pre-tax earnings for the three and six months ending June 30, 2012, and 2011.

| | **2012** | **2011** |
|---|---|---|
| **Estimated credit losses as of March 31,** | $5,041 | $3,938 |
| Additions for credit losses for securities on which OTTI has been previously recognized | 336 | 456 |
| Additions for credit losses for securities on which OTTI has not been previously recognized | --- | 133 |
| Reductions for securities paid off during the period | 419 | --- |
| **Estimated credit losses as of June 30,** | $4,958 | $4,527 |
| | | |
| **Estimated credit losses as of prior year-end,** | $4,697 | $3,373 |
| Additions for credit losses for securities on which OTTI has been previously recognized | 622 | 1,021 |
| Additions for credit losses for securities on which OTTI has not been previously recognized | 58 | 133 |
| Reductions for securities paid off during the period | 419 | --- |
| **Estimated credit losses as of June 30,** | $4,958 | $4,527 |

Upon initial impairment of a security, total OTTI losses represent the excess of the amortized cost over the fair value. For subsequent impairments of the same security, total OTTI losses represent additional credit losses and or declines in fair value subsequent to the previously recorded OTTI losses, if applicable. Unrealized OTTI losses recognized in accumulated other comprehensive income ( OCI ) represent the non-credit component of OTTI losses on debt securities. Net impairment losses recognized in earnings represent the credit component of OTTI losses on debt securities.

As of June 30, 2012, the Company held fifteen private-label MBS (debt securities) with a total amortized cost (i.e. carrying value) of $4,417 for which OTTI losses have previously been recognized in pre-tax earnings (dating back to the fourth quarter of 2008). For eleven of these securities, the Company previously recognized credit losses in excess of the unrealized losses in accumulated OCI, creating an unrealized gain of $318, net of tax, as included in accumulated OCI as of June 30, 2012. For the remaining four securities, the total OTTI losses included in accumulated OCI amounted to $198, net of tax, as of June 30, 2012. As of June 30, 2012, the total net unrealized gains included in accumulated OCI for securities held where OTTI has been historically recognized in pre-tax earnings amounted to $119, net of tax, compared with $423 at December 31, 2011.

As of June 30, 2012, based on a review of each of the remaining securities in the securities portfolio, the Company concluded that it expects to recover its amortized cost basis for such securities. This conclusion was based on the issuers continued satisfaction of the securities obligations in accordance with their contractual terms and the expectation that they will continue to do so through the maturity of the security, the expectation that the Company will receive the entire amount of future contractual cash flows, as well as the evaluation of the fundamentals of the issuers financial condition and other objective evidence. Accordingly, the Company concluded that the declines in the values of those securities were temporary and that any additional other-than-temporary impairment charges were not appropriate at June 30, 2012. As of that date, the Company did not intend to sell nor anticipated that it would more-likely-than-not be required to sell any of its impaired securities, that is, where fair value is less than the cost basis of the security.

The following table summarizes the fair value of securities with continuous unrealized losses for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer as of June 30, 2012 and December 31, 2011. All securities referenced are debt securities. At June 30, 2012, and December 31, 2011, the Company did not hold any common stock or other equity securities in its securities portfolio.

| | **Less than 12 months** | | | **12 months or longer** | | | **Total** | | |
|---|---|---|---|---|---|---|---|---|---|
| **June 30, 2012** | **Estimated Fair Value** | **Number of Investments** | **Unrealized Losses** | **Estimated Fair Value** | **Number of Investments** | **Unrealized Losses** | **Estimated Fair Value** | **Number of Investments** | **Unrealized Losses** |
| **Description of Securities:** | | | | | | | | | |
| Mortgage-backed securities: | | | | | | | | | |
| US Government-sponsored enterprises | $ 24,431 | 25 | $133 | $ --- | --- | $ --- | $24,431 | 25 | $ 133 |
| US Government agency | 2,575 | 4 | 16 | 130 | 3 | 1 | 2,705 | 7 | 17 |
| Private label | 1,317 | 5 | 26 | 3,821 | 19 | 700 | 5,138 | 24 | 726 |
| Obligations of states and political subdivisions thereof | 18,284 | 36 | 282 | 8,466 | 40 | 1,108 | 26,750 | 76 | 1,390 |
| Total | $46,607 | 70 | $457 | $12,417 | 62 | $1,809 | $59,024 | 132 | $2,266 |

| | **Less than 12 months** | | | **12 months or longer** | | | **Total** | | |
|---|---|---|---|---|---|---|---|---|---|
| | **Estimated** | | | **Estimated** | | | **Estimated** | | |

| **December 31, 2011** | **Fair Value** | **Number of Investments** | **Unrealized Losses** | **Fair Value** | **Number of Investments** | **Unrealized Losses** | **Fair Value** | **Number of Investments** | **Unrealized Losses** |
|---|---|---|---|---|---|---|---|---|---|
| **Description of Securities:** | | | | | | | | | |
| Mortgage-backed securities: | | | | | | | | | |
| US Government-sponsored enterprises | $ 15,870 | 13 | $127 | $ 20 | 1 | $ --- | $15,890 | 14 | $ 127 |
| US Government agency | 9,934 | 10 | 22 | 59 | 3 | 1 | 9,993 | 13 | 23 |
| Private label | 1,613 | 8 | 219 | 6,807 | 26 | 1,273 | 8,420 | 34 | 1,492 |
| Obligations of states and political subdivisions thereof | 703 | 4 | 25 | 14,770 | 61 | 2,433 | 15,473 | 65 | 2,458 |
| Total | $ 28,120 | 35 | $393 | $21,656 | 91 | $3,707 | $49,776 | 126 | $4,100 |

For securities with unrealized losses, the following information was considered in determining that the impairments were not other-than-temporary:

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***Mortgage-backed securities issued by U.S. Government-sponsored enterprises***: As of June 30, 2012, the total unrealized losses on these securities amounted to $133, compared with $127 at December 31, 2011. All of these securities were credit rated AA+ by the major credit rating agencies. Company management believes these securities have minimal credit risk, as these Government-sponsored enterprises play a vital role in the nation s financial markets. Management s analysis indicates that the unrealized losses at June 30, 2012 were attributed to changes in current market yields and pricing spreads for similar securities since the date the underlying securities were purchased, and does not consider these securities to be other-than-temporarily impaired at June 30, 2012.

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***Mortgage-backed securities issued by U.S. Government agencies:*** As of June 30, 2012, the total unrealized losses on these securities amounted to $17, compared with $23 at December 31, 2011. All of these securities were credit rated AA+ by the major credit rating agencies. Management s analysis indicates that these securities bear little or no credit risk because they are backed by the full faith and credit of the United States. The Company attributes the unrealized losses at June 30, 2012 to changes in current market yields and pricing spreads for similar securities since the date the underlying securities were purchased, and does not consider these securities to be other-than-temporarily impaired at June 30, 2012.

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***Private label mortgage-backed securities***: As of June 30, 2012, the total unrealized losses on the Bank s private label mortgage-backed securities amounted to $726, compared with $1,492 at December 31, 2011. The Company attributes the unrealized losses at June 30, 2012 to the current illiquid market for non-agency mortgage-backed securities, a seriously depressed and still declining housing market, significantly elevated levels of home foreclosures, risk-related market pricing discounts for non-agency mortgage-backed securities and credit rating downgrades on certain private label mortgage-backed securities owned by the Company. Based upon the foregoing considerations and the expectation that the Company will receive all of the future contractual cash flows related to amortized cost on these securities, the Company does not consider there to be any additional other-than-temporary impairment with respect to these securities at June 30, 2012.

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***Obligations of states of the U.S. and political subdivisions thereof***: As of June 30, 2012, the total unrealized losses on the Bank s municipal securities amounted to $1,390, compared with $2,458 at December 31, 2011. The Bank s municipal securities primarily consist of general obligation bonds and to a lesser extent, revenue bonds. General obligation bonds carry less risk, as they are supported by the full faith, credit and taxing authority of the issuing government and in the cases of school districts, are additionally supported by state aid. Revenue bonds are generally backed by municipal revenue streams generated through user fees or lease payments associated with specific municipal projects that have been financed. At June 30, 2012, all municipal bond issuers were current on contractually obligated interest and principal payments. At June 30, 2012, the Bank s municipal bond portfolio did not contain any below investment grade securities as reported by major credit rating agencies.

The Company attributes the unrealized losses at June 30, 2012, to changes in prevailing market yields and pricing spreads since the date the underlying securities were purchased, driven in part by current media attention and market concerns about the prolonged recovery from the national economic recession and the impact it might have on the future financial stability of municipalities throughout the country. Accordingly, the Company does not consider these municipal securities to be other-than-temporarily impaired at June 30, 2012.

At June 30, 2012, the Company had no intent to sell nor believed it is more-likely-than-not that it would be required to sell any of its impaired securities as identified and discussed immediately above, and therefore did not consider these securities to be other-than-temporarily impaired as of that date.

***Securities Gains and Losses:*** The following table summarizes realized gains and losses and other-than-temporary impairment losses on securities available for sale for the three and six months ended June 30, 2012 and 2011.

| | Proceeds from Sale of Securities Available | Realized Gains | Realized Losses | Other Than Temporary Impairment | Net |
|---|---|---|---|---|---|

| | for Sale | | | Losses | |
|---|---|---|---|---|---|
| **Three months ended June 30,** | | | | | |
| **2012** | $13,160 | $ 683 | $ 13 | $ 336 | $ 334 |
| **2011** | $ 9,089 | $ 535 | $ --- | $ 589 | $ (54) |
| **Six months ended June 30,** | | | | | |
| **2012** | $24,233 | $1,256 | $ 19 | $ 680 | $ 557 |
| **2011** | $22,473 | $1,320 | $ --- | $ 1,154 | $ 166 |

**Note 5: Loans and Allowance for Loan Losses**

Loans are carried at the principal amounts outstanding adjusted by partial charge-offs and net deferred loan origination costs or fees.

Interest on loans is accrued and credited to income based on the principal amount of loans outstanding. Residential real estate and home equity loans are generally placed on non-accrual status when reaching 90 days past due, or in process of foreclosure, or sooner if judged appropriate by management. Consumer loans are generally placed on non-accrual status when reaching 90 days or more past due, or sooner if judged appropriate by management. Secured consumer loans are written down to realizable value and unsecured consumer loans are charged-off upon reaching 120 days past due. Commercial real estate loans and commercial business loans that are 90 days or more past due are generally placed on non-accrual status, unless secured by sufficient cash or other assets immediately convertible to cash, and the loan is in the process of collection. Commercial real estate and commercial business loans may be placed on non-accrual status prior to the 90 days delinquency date if considered appropriate by management. When a loan has been placed on non-accrual status, previously accrued and uncollected interest is reversed against interest on loans. A loan can be returned to accrual status when principal is reasonably assured and the loan has performed for a period of time, generally six months.

Commercial real estate and commercial business loans are considered impaired when it becomes probable the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and collateral value. In considering loans for evaluation of impairment, management generally excludes smaller balance, homogeneous loans: residential mortgage loans, home equity loans, and all consumer loans, unless such loans were restructured in a troubled debt restructuring. These loans are collectively evaluated for risk of loss.

When a loan is classified as non-accrual or impaired, any payments received are typically applied to reduce the principal balance of the loan. In situations where the Company reasonably believes there is no longer doubt regarding the ultimate collectability of principal on a non-accrual or impaired loan, subsequent