2012
Annual Report

NORTHUMBERLAND
BANCORP

NORTHUMBERLAND BANCORP
AUDITED CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2012

2012 ANNUAL REPORT
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Northumberland Bancorp

245 Front Street • P.O. Box 271 • Northumberland, PA 17857
(570) 473-3531 Fax (570) 473-9697

March 28, 2013

To our shareholders:

I am again very pleased to report that Northumberland Bancorp (the Company), parent of The Northumberland National Bank (the bank), earned a record $4,455,000, an increase of 5.8% from the $4,212,000 earned in 2011. Assets grew approximately 3% from the prior year.

Many factors contributed to our improved earnings, including an increase in net interest income, a lower provision for loan loss, and higher non-interest income. The increase in net interest income was a result of higher levels of earning assets. Due to the continued low interest rate environment, the bank's net interest margin decreased from 3.02% in 2011 to 2.94% in 2012. Management constantly evaluates the bank's asset mix and deposit pricing in order to reduce the impact of lower interest rates on the bank's financial performance. Non-interest income increased $906,000 as a result of increased earnings from trust operations ($61,000), secondary mortgage operation ($608,000), and the purchase of bank owned life insurance ($145,000). The bank owned life insurance was purchased as a vehicle to help fund the bank employee life insurance benefits. Offsetting these increases was an increase in non-interest expense of $940,000. This increase was the result of operating the Middleburg Office, which was opened in September 2011, for a full year; increased pension expenses primarily as a result of lower discount rates applied to the bank's liability; increases in other employee benefits; and faster amortization of mortgage servicing rights associated with the bank's secondary mortgage operations.

The provision for loan loss was reduced by $186,000. Bank management's evaluation of various factors including the level of classification loans, historic loss factors and certain environmental factors, together with a decrease in loans outstanding allowed the bank to reduce the provision for losses by $186,000. Management continues to believe the allowance is adequate to absorb losses expected in the portfolio. As of December 31, 2012, loans on non-accrual and past due loans remain low at 1.26% compared to 2.94% for the bank's peer group.

The Company remains well capitalized, with tier one capital to average assets increasing to 8.87% in 2012 from 8.37% in 2011. The Company was able to increase its capital while continuing to increase its dividend. In 2012, the company paid dividends of $.60 per share, an increase of 15.4% from the $.52 paid in 2011. As of the date of this letter, the last closing price of your Company's stock was $32 per share compared with $28 which was reported in last year's annual report.

In late 2012, with much excitement, the Bank announced the formation of a new subsidiary, NNB Financial Services LLC, a partnership with Charles Schlegel III to offer life insurance products and other non traditional bank investment products to our customers. The concept for this new subsidiary was several years in the making as we formulated a plan that we felt would be the best fit for our customers and whose values would blend into the culture of the bank. We believe that this partnership will provide significant benefits to our customers and will provided future non-interest income to the bank and thereby benefit our shareholders in the years to come.

This year will mark the 110th anniversary for the bank and we are excited to celebrate this important milestone in banking. The trust and value that both our customers and you, our valued shareholders, place on our relationships continues to serve us well. We look for continued growth in assets and earnings as we move through 2013. I want to take this opportunity to thank the management and employees of the bank for their commitment to making The Northumberland National Bank a success, and I want to personally thank you for being a shareholder of Northumberland Bancorp and for your continued loyalty and support.

Sincerely,

J. Donald Steele, Jr.
Chairman and President

SNODGRASS

CERTIFIED PUBLIC ACCOUNTANTS
AND CONSULTANTS

INDEPENDENT AUDITOR'S REPORT

Board of Directors and Stockholders
Northumberland Bancorp

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Northumberland Bancorp and subsidiary which comprise the consolidated balance sheet as of December 31, 2012 and 2011; the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended; and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Northumberland Bancorp and subsidiary as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

S. R. Snodgrass, A.C.

Wexford, Pennsylvania
March 28, 2013

NORTHUMBERLAND BANCORP
CONSOLIDATED BALANCE SHEET
FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(Amounts in thousands except per share data)

	2012	2011
ASSETS		
Cash and due from banks	$ 2,441	$ 1,945
Interest-bearing deposits in other banks	5,595	10,768
Total cash and cash equivalents	8,036	12,713
Investment securities available for sale	188,356	170,065
Investment securities held to maturity (fair value of $4,477 and $4,149)	4,444	4,099
Total investment securities	192,800	174,164
Loans held for sale	4,515	1,166
Loans	241,110	251,037
Less allowance for loan losses	2,458	2,538
Net loans	238,652	248,499
Premises and equipment	8,564	8,780
Bank-owned life insurance	6,146	-
Accrued interest and other assets	5,690	5,622
TOTAL ASSETS	$ 464,403	$ 450,944
LIABILITIES		
Deposits:		
Non-interest-bearing demand	$ 47,737	$ 35,116
Interest-bearing demand	164,447	148,596
Savings	63,840	61,500
Time deposits	144,070	159,891
Total deposits	420,094	405,103
Other borrowings	-	5,072
Accrued interest and other liabilities	2,554	2,616
TOTAL LIABILITIES	422,648	412,791
STOCKHOLDERS' EQUITY		
Common stock, par value $0.10; 5,000,000 shares authorized, 1,502,500 shares issued	150	150
Capital surplus	3,832	3,832
Retained earnings	39,567	35,914
Accumulated other comprehensive income	309	282
	43,858	40,178
Treasury stock, at cost (169,317 and 166,978 shares)	(2,096)	(2,025)
TOTAL NORTHUMBERLAND BANCORP STOCKHOLDERS' EQUITY	41,762	38,153
Noncontrolling interest	(7)	-
TOTAL STOCKHOLDERS' EQUITY	41,755	38,153
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 464,403	$ 450,944

See accompanying notes to the consolidated financial statements.

NORTHUMBERLAND BANCORP
CONSOLIDATED STATEMENT OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(Amounts in thousands except per share data)	2012	2011
INTEREST AND DIVIDEND INCOME		
Interest and fees on loans:		
Taxable	$ 13,139	$ 14,368
Tax-exempt	50	30
Federal funds sold	-	3
Interest on interest-bearing deposits in other banks	22	20
Interest and dividends on investment securities:		
Taxable interest	1,746	1,893
Tax-exempt interest	1,619	1,527
Dividends	16	15
Total interest and dividend income	16,592	17,856
INTEREST EXPENSE		
Deposits	4,558	5,722
Other borrowings	115	269
Total interest expense	4,673	5,991
NET INTEREST INCOME	11,919	11,865
Provision for loan losses	64	250
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	11,855	11,615
NON-INTEREST INCOME		
Service charges on deposit accounts	760	760
Trust services income	643	582
Investment securities gains, net	342	384
Gain on sale of loans	1,486	878
Earnings on bank-owned life insurance	145	-
Other income	561	427
Total non-interest income	3,937	3,031
NON-INTEREST EXPENSE		
Salaries and employee benefits	5,488	4,873
Occupancy expense, net	633	581
Equipment expense	669	623
Professional fees	372	388
Data processing	349	387
Shares tax	237	208
Federal deposit insurance expense	228	332
Other expense	1,971	1,615
Total non-interest expense	9,947	9,007
Income before income taxes	5,845	5,639
Income taxes	1,397	1,427
NET INCOME ATTRIBUTABLE TO NORTHUMBERLAND BANCORP	4,448	4,212
Less: net loss attributable to noncontrolling interest	(7)	-
NET INCOME	$ 4,455	$ 4,212
EARNINGS PER SHARE	$ 3.34	$ 3.15
WEIGHTED-AVERAGE SHARES OUTSTANDING	1,335,515	1,335,522

See accompanying notes to the consolidated financial statements.

NORTHUMBERLAND BANCORP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(Amounts in thousands except per share data)

	2012	2011
Net income	$ 4,448	$ 4,212
Other comprehensive income:		
Unrealized holding gains on investment securities available for sale	593	1,389
Tax effect	(202)	(472)
Reclassification adjustment for investment securities gains recognized in net income	(342)	(384)
Tax effect	116	130
Change in unrecognized pension costs	(210)	(1,379)
Tax effect	71	469
Other comprehensive income (loss), net of tax	26	(247)
Net comprehensive income before noncontrolling interest	4,474	3,965
Less: net loss attributable to noncontrolling interest	(7)	-
Comprehensive income	$ 4,481	$ 3,965

See accompanying notes to the consolidated financial statements.

NORTHUMBERLAND BANCORP
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
FOR YEARS ENDED DECEMBER 31, 2012 AND 2011

(Amounts in thousands except per share data)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Noncontrolling Interest	Total
Balance, December 31, 2010	$ 150	$ 3,832	$ 32,396	$ 529	$ (2,025)	$ -	$ 34,882
Net income			4,212				4,212
Other comprehensive loss				(247)			(247)
Dividends declared ($.52 per share)			(694)				(694)
Balance, December 31, 2011	150	3,832	35,914	282	(2,025)	-	38,153
Net income			4,455			(7)	4,448
Other comprehensive income				27			27
Dividends declared ($.60 per share)			(802)				(802)
Purchase of treasury stock (2,339 shares)					(71)		(71)
Balance, December 31, 2012	$ 150	$ 3,832	$ 39,567	$ 309	$ (2,096)	$ (7)	$ 41,755

See accompanying notes to the consolidated financial statements.

NORTHUMBERLAND BANCORP
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(Amounts in thousands except per share data)

	2012	2011
OPERATING ACTIVITIES		
Net income	$ 4,448	$ 4,212
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	64	250
Depreciation, amortization, and accretion, net	1,788	2,350
Proceeds from sale of loans held for sale	33,454	32,912
Gain on sale of loans	(1,486)	(878)
Originations of residential loans held for sale	(35,317)	(25,590)
Investment securities gains, net	(342)	(384)
Deferred income taxes	(129)	289
Earnings on bank-owned life insurance	(145)	-
Write down of mortgage servicing rights	152	-
Decrease in prepaid federal deposit insurance	199	304
Increase in accrued interest receivable	(47)	(240)
Decrease in accrued interest payable	(66)	(23)
Loss on sale of other real estate owned	27	17
Other, net	(290)	(414)
Net cash provided by operating activities	2,310	12,805
INVESTING ACTIVITIES		
Investment securities available for sale:		
Proceeds from sales	23,064	21,285
Proceeds from maturities or redemptions	27,418	30,736
Purchases	(69,084)	(83,736)
Investment securities held to maturity:		
Proceeds from sales	101	167
Proceeds from maturities or redemptions	915	1,815
Purchases	(1,399)	(2,247)
Decrease (increase) in loans, net	10,784	(2,268)
Purchases of loans	(1,495)	(3,746)
Purchases of premises and equipment	(336)	(1,553)
Purchases of regulatory stock	(191)	(341)
Redemption of regulatory stock	-	150
Purchase of bank-owned life insurance	(6,000)	-
Proceeds from sale of real estate owned	190	947
Net cash used for investing activities	(16,033)	(38,791)
FINANCING ACTIVITIES		
Net increase in deposits	14,991	29,904
Net decrease in short-term borrowings	-	(422)
Repayment of long-term debt	(5,072)	-
Cash dividends paid	(802)	(694)
Purchase of treasury stock	(71)	-
Net cash provided by financing activities	9,046	28,788
Increase (decrease) in cash and cash equivalents	(4,677)	2,802
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	12,713	9,911
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 8,036	$ 12,713

See accompanying notes to the consolidated financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of significant accounting and reporting policies applied in the presentation of the accompanying consolidated financial statements follows:

Nature of Operations and Basis of Presentation

Northumberland Bancorp (the "Company") is a Pennsylvania corporation and is registered under the Bank Holding Company Act. The Company was organized as the holding company of its wholly owned subsidiary, The Northumberland National Bank (the "Bank"). The Bank is a nationally chartered commercial bank located in Northumberland, Pennsylvania. The Bank's service area includes portions of Northumberland, Snyder, Union, and Montour counties in Pennsylvania. The Company and the Bank derive substantially all of their income from banking and bank-related services, which includes interest earnings on commercial, commercial mortgage, residential real estate, and consumer loan financing as well as interest earnings on investment securities and deposit and trust services to its customers. The Bank created a new subsidiary, NNB Financial Services, during 2012 for the purpose of selling financial and insurance products. The Company is supervised by the Federal Reserve Board, while the Bank is subject to regulation and supervision by the Office of the Comptroller of the Currency.

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, the Bank. Intercompany activity has been eliminated in consolidation.

The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles and with general practice within the banking industry. In preparing the financial statements, management is required to make certain estimates and assumptions that affect the reported amounts of assets and liabilities as of the Consolidated Balance Sheet date and revenues and expenses for the period. Actual results could differ significantly from those estimates.

Investment Securities

Investment securities are classified at the time of purchase, based on management's intention and ability, as securities held to maturity or securities available for sale. Debt securities acquired with the intent and ability to hold to maturity are stated at cost adjusted for amortization of premium and accretion of discount that are computed using the level yield method and recognized as adjustments of interest income. Certain other debt securities have been classified as available for sale to serve principally as a source of liquidity. Unrealized holding gains and losses for available-for-sale securities are reported as a separate component of stockholders' equity, net of tax, until realized. Realized securities gains and losses are computed using the specific identification method. Interest and dividends on investment securities are recognized as income when earned.

Securities are periodically reviewed for other-than-temporary impairment based upon a number of factors, including, but not limited to, the length of time and extent to which the market value has been less than cost, the financial condition of the underlying issuer, the ability of the issuer to meet contractual obligations, the likelihood of the security's ability to recover any decline in its market value, and whether or not the Company intends to sell the security or whether it's more likely than not that the Company would be required to sell the security before its anticipated recovery in market value. A decline in value that is considered to be other than temporary is recorded as a loss within non-interest income in the Consolidated Statement of Income.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Federal Home Loan Bank Stock

The Bank is a member of the Federal Home Loan Bank ("FHLB") of Pittsburgh and as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. The stock is bought from and sold to the FHLB based upon its $100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost, and evaluated for impairment as necessary. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted; (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance; (c) the impact of legislative and regulatory changes on the customer base of the FHLB; and (d) the liquidity position of the FHLB. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein.

Loans Held For Sale and Loans Serviced

Loans held for sale are carried at the lower of cost or estimated fair value, as determined on an aggregate basis. Gains and losses on sales of loans held for sale are recognized on settlement dates and are determined by the difference between the sale proceeds and the carrying value of loans. All sales are made with limited recourse. Loans held for sale were $4,515,000 and $1,166,000 at December 31, 2012 and 2011, respectively. At December 31, 2012 and 2011, the amounts of loans serviced by the Company for the benefit of others were $80,683,000 and $60,746,000, respectively.

Loans

Loans are reported at their principal amount, net of unearned income and the allowance for loan losses. Interest income on all loans is recognized on an accrual basis. Nonrefundable loan fees and certain direct costs are deferred and amortized over the life of the loans using the interest method. The amortization is reflected as an interest yield adjustment, and the deferred portion of the net fees and costs is reflected as part of the loan balance. Accrual of interest is discontinued when, in the opinion of management, reasonable doubt exists as to the collectibility of additional interest. Loans are returned to accrual status when past-due interest is collected and the collection of principal is probable.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable losses inherent in its loan portfolio. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance, and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses charged to operations. The provision for loan losses is based on management's periodic evaluation of individual loans, economic factors, past loan loss experience, changes in the composition and volume of the portfolio, and other relevant factors. The estimates used in determining the adequacy of the allowance for loan losses, including the amounts and timing of future cash flows expected on impaired loans, are particularly susceptible to changes in the near term.

Impaired loans are commercial and commercial real estate loans for which it is probable the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Company individually evaluates such loans for impairment and does not aggregate loans by major risk classifications. The definition of "impaired loans" is not the same as the definition of "nonaccrual loans," although the two categories overlap. The Company may choose to place a loan on nonaccrual status due to payment delinquency or uncertain collectibility, while not classifying the loan as impaired if the loan is not a commercial or commercial real estate loan. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of impaired loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loans. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets, which range from 3 to 20 years for furniture, fixtures, and equipment and 15 to 50 years for buildings and leasehold improvements. Expenditures for maintenance and repairs are charged against income as incurred. Costs of major additions and improvements are capitalized.

Mortgage Servicing Rights ("MSRs")

The Company has agreements for the express purpose of selling loans in the secondary market. The Company maintains servicing rights for certain loans. Originated MSRs are recorded by allocating total costs incurred between the loan and servicing rights based on their relative fair values. MSRs are amortized in proportion to the estimated servicing income over the estimated life of the servicing portfolio. Annually, the Company performs an impairment review of the MSRs and recognizes impairment through a valuation account. The Company recognized a $152,000 impairment loss on MSRs during 2012. No impairment was recognized in 2011. MSRs are a component of other assets on the Consolidated Balance Sheet.

(Amounts in thousands except per share data)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Real Estate Owned

Real estate owned acquired in settlement of foreclosed loans is carried as a component of other assets at the lower fair value less estimated costs to sell. Direct cost incurred in the foreclosure process and subsequent holding costs incurred on such properties are recorded as expenses of current operations.

Advertising Costs

Advertising costs are expensed as the costs are incurred. Advertising expenses amounted to $157,000 and $145,000 for 2012 and 2011, respectively.

Income Taxes

The Company and the Bank file a consolidated federal income tax return. Deferred tax assets or liabilities are computed based on the difference between the financial statement and income tax basis of assets and liabilities using the enacted marginal tax rates. Deferred income tax expenses or benefits are based on the changes in the deferred tax asset or liability from period to period.

Pension Plan

The Bank has a noncontributory defined benefit pension plan that covers all eligible employees. Benefits are based upon years of service, the employee's compensation, and age at retirement. The Bank's contribution is actuarially determined and is intended to meet the current and projected obligations of the plan.

Trust Assets and Income

Assets held by the Bank in a fiduciary or agency capacity for its customers are not included in the accompanying financial statements, since such items are not assets of the Bank. In accordance with banking industry practice, Trust Department income is recognized on the cash basis and is not materially different than if it was reported on the accrual basis.

Comprehensive Income (Loss)

The Company is required to present comprehensive income (loss) and its components in a full set of general-purpose financial statements for all periods presented. Other comprehensive income (loss) is composed of net unrealized holding gains or losses on its available-for-sale investment and mortgage-backed securities portfolio, as well as changes in unrecognized pension cost.

The components of accumulated other comprehensive income, net of tax, as of year-end were as follows:

	2012	2011
Net unrealized gain on securities available for sale	$ 2,223	$ 2,057
Net unrecognized pension cost	(1,914)	(1,775)
Total	$ 309	$ 282

Earnings Per Share

The Company currently maintains a simple capital structure; therefore, there are no dilutive effects on earnings per share. As such, earnings per share are calculated using the weighted-average number of shares outstanding for the periods.

(Amounts in thousands except per share data)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash Flow Information

The Company has defined cash and cash equivalents as those amounts included in the Consolidated Balance Sheet captions "Cash and due from banks," and "Interest-bearing deposits in other banks," with original maturities of 90 days or less.

	2012	2011
Cash paid during the year for:		
Interest	$ 4,739	$ 6,014
Income taxes	1,268	933
Noncash investing transactions:		
Transfer of loans to real estate earned	233	846

Reclassification of Comparative Amounts

Certain comparative amounts for the prior year have been reclassified to conform to current-year classifications. Such reclassifications had no effect on stockholders' equity or net income.

NOTE 2 - INVESTMENT SECURITIES

The amortized cost and fair values of investment securities are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2012 AVAILABLE FOR SALE				
Obligations of states and political subdivisions	$ 59,083	$ 2,083	$ (72)	$ 61,094
Mortgage-backed securities in government-sponsored entities	125,040	1,623	(281)	126,382
Corporate debt securities	750	-	(8)	742
Subtotal	184,873	3,706	(361)	188,218
Equity securities in financial institutions	115	23	-	138
Total	$ 184,988	$ 3,729	$ (361)	$ 188,356

(Amounts in thousands except per share data)

NOTE 2 - INVESTMENT SECURITIES (Continued)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2011 AVAILABLE FOR SALE				
U.S. government agency securities	$ 1,000	$ -	$ -	$ 1,000
Obligations of states and political subdivisions	50,440	2,132	(22)	52,550
Mortgage-backed securities in government-sponsored entities	114,900	1,238	(220)	115,918
Corporate debt securities	500	-	(33)	467
Subtotal	166,840	3,370	(275)	169,935
Equity securities in financial institutions	108	22	-	130
Total	$ 166,948	$ 3,392	$ (275)	$ 170,065

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2012 HELD TO MATURITY				
Obligations of states and political subdivisions	$ 4,194	$ 39	$ (6)	$ 4,227
Corporate debt securities	250	-	-	250
Total	$ 4,444	$ 39	$ (6)	$ 4,477

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2011 HELD TO MATURITY				
Obligations of states and political subdivisions	$ 3,598	$ 48	$ (1)	$ 3,645
Corporate debt securities	501	3	-	504
Total	$ 4,099	$ 51	$ (1)	$ 4,149

(Amounts in thousands except per share data)

NOTE 2 - INVESTMENT SECURITIES (Continued)

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31, 2012 and 2011.

2012	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Obligations of states and political subdivisions	$ 6,327	$ (76)	$ 655	$ (2)	$ 6,982	$ (78)
Mortgage-backed securities in government-sponsored entities	26,388	(189)	14,308	(92)	40,696	(281)
Corporate debt securities	249	(1)	243	(7)	492	(8)
Total	$ 32,964	$ (266)	$ 15,206	$ (101)	$ 48,170	$ (367)

2011	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Obligations of states and political subdivisions	$ 2,768	$ (21)	$ 476	$ (1)	$ 3,244	$ (22)
Mortgage-backed securities in government-sponsored entities	25,891	(164)	9,453	(56)	35,344	(220)
Corporate debt securities	467	(33)	-	-	467	(33)
Total	$ 29,126	$ (218)	$ 9,929	$ (57)	$ 39,055	$ (275)

The Company reviews its position quarterly and has asserted that at December 31, 2012 and 2011, the declines outlined in the above table represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. There were 87 positions that were temporarily impaired at December 31, 2012. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, sector credit ratings changes, or Company-specific ratings changes that are not expected to result in the noncollection of principal and interest during the period.

(Amounts in thousands except per share data)

NOTE 2 - INVESTMENT SECURITIES (Continued)

The amortized cost and fair value of debt securities at December 31, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 2,140	$ 2,157	$ 446	$ 450
Due after one year through five years	30,104	31,164	3,998	4,027
Due after five years through ten years	93,444	95,491	-	-
Due after ten years	59,185	59,406	-	-
Total	$ 184,873	$ 188,218	$ 4,444	$ 4,477

Proceeds from the sales of available-for-sale securities during 2012 amounted to $23,064,000 resulting in gross gains and gross losses of $433,000 and $92,000, respectively. Proceeds from the sales of available-for-sale securities during 2011 amounted to $21,285,000 resulting in gross gains and gross losses of $435,000 and $52,000, respectively.

The Company sold a $101,000 held-to-maturity security during 2012. The held-to-maturities securities portfolio is not considered tainted because there was evidence that there was significant deterioration in the issuer's creditworthiness. The sale resulted in a gain of $1,000. The Company sold a $166,000 held-to-maturity security during 2011 which also had evidence of significant deterioration in the issuer's creditworthiness. The sale also resulted in a gain of $1,000.

Investment securities with fair values of $75,311,000 and $77,605,000 at December 31, 2012 and 2011, respectively, were pledged to secure public deposits and other purposes as required by law.

NOTE 3 - LOANS

Major classifications of loans are summarized as follows:

	2012	2011
Commercial	$ 52,472	$ 53,013
Commercial real estate	39,492	41,326
Residential real estate	144,676	151,860
Consumer	4,470	4,838
	241,110	251,037
Less allowance for loan losses	2,458	2,538
Net loans	$ 238,652	$ 248,499

The Company grants residential, commercial, and consumer loans to customers throughout its trade area, which is concentrated in North Central Pennsylvania. Although the Company has a diversified loan portfolio at December 31, 2012 and 2011, a substantial portion of its debtors' ability to honor their loan agreements is dependent upon the economic stability of its immediate trade area.

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses by portfolio segment are as follows:

	2012					
	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Beginning balance	$ 545	$ 446	$ 1,201	$ 46	$ 300	$ 2,538
Charge-offs	(82)	(10)	(83)	(17)	-	(192)
Recoveries	18	-	25	5	-	48
Provision	122	55	(87)	(5)	(21)	64
Ending balance	$ 603	$ 491	$ 1,056	$ 29	$ 279	$ 2,458

	2011					
	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Beginning balance	$ 693	$ 416	$ 1,342	$ 66	$ 24	$ 2,541
Charge-offs	(392)	-	(237)	(2)	-	(631)
Recoveries	210	-	166	2	-	378
Provision	34	30	(70)	(20)	276	250
Ending balance	$ 545	$ 446	$ 1,201	$ 46	$ 300	$ 2,538

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Company has segmented certain loans in the portfolio by product type. Loans are segmented into the following pools: commercial, commercial real estate loans, residential real estate loans, and consumer loans. Historical loss percentages for each risk category are calculated and used as the basis for calculating allowance allocations. These historical loss percentages are calculated over a two-year period for all portfolio segments. Certain qualitative factors are then added to the historical allocation percentage to get the adjusted factor to be applied to nonclassified loans. The following qualitative factors are analyzed for each portfolio segment:

- Levels of and trends in delinquencies
- Trends in volume and terms
- Trends in credit quality ratings
- Changes in management and lending staff
- Economic trends
- Concentrations of credit

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

These qualitative factors are reviewed each quarter and adjusted based upon relevant changes within the portfolio. During 2012, the qualitative factors for commercial loans increased slightly and in 2011 the qualitative factors for residential real estate loans was increased slightly. The factors for the other portfolio segments remained the same during both years.

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses of $2,458,000 and $2,538,000 adequate to cover loan losses inherent in the loan portfolio, at December 31, 2012 and 2011. The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2012 and 2011:

	2012					
	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:						
Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -
Collectively evaluated for impairment	603	491	1,056	29	279	2,458
Total	$ 603	$ 491	$ 1,056	$ 29	$ 279	$ 2,458
Loans:						
Individually evaluated for impairment	$ 29	$ 98	$ -	$ -	$ -	$ 127
Collectively evaluated for impairment	52,443	39,394	144,676	4,470	-	240,983
Total	$ 52,472	$ 39,492	$ 144,676	$ 4,470	$ -	$ 241,110

	2011					
	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:						
Individually evaluated for impairment	$ 18	$ 2	$ -	$ -	$ -	$ 20
Collectively evaluated for impairment	527	444	1,201	46	300	2,518
Total	$ 545	$ 446	$ 1,201	$ 46	$ 300	$ 2,538
Loans:						
Individually evaluated for impairment	$ 55	$ 101	$ -	$ -	$ -	$ 156
Collectively evaluated for impairment	52,958	41,225	151,860	4,838	-	250,881
Total	$ 53,013	$ 41,326	$ 151,860	$ 4,838	$ -	$ 251,037

Credit Quality Information

The Company's internally assigned grades are as follows:

Pass loans are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. There are five sub-grades within the Pass category to further distinguish the loan.

Special Mention loans are loans for which a potential weakness or risk exists, which could cause a more serious problem if not corrected.

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Quality Information (Continued)

Substandard loans have a well-defined weakness based on objective evidence and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful loans have all the weaknesses inherent in a Substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

Loss loans are considered uncollectible, or of such value that continuance as an asset is not warranted.

The following tables represent credit exposures by internally assigned grades for the years ended December 31, 2012 and 2011. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on experiences with similarly graded loans.

	2012				
	Obligations of State and Political Subdivisions	Other Commercial Loans	Loans for Investment Properties	Other Commercial Real Estate Loans	Total
Pass	$ 20,627	$ 28,371	$ 17,814	$ 18,970	$ 85,782
Special Mention	-	904	1,441	-	2,345
Substandard	-	2,570	54	1,213	3,837
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Ending balance	$ 20,627	$ 31,845	$ 19,309	$ 20,183	$ 91,964

	2011				
	Obligations of State and Political Subdivisions	Other Commercial Loans	Loans for Investment Properties	Other Commercial Real Estate Loans	Total
Pass	$ 21,153	$ 26,644	$ 19,969	$ 20,841	$ 88,607
Special Mention	-	1,636	275	-	1,911
Substandard	-	3,580	70	171	3,821
Doubtful	-	-	-	-	-
Loss	-	-	-	-	-
Ending balance	$ 21,153	$ 31,860	$ 20,314	$ 21,012	$ 94,339

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables present performing and nonperforming residential real estate and consumer loans based on payment activity for the years ended December 31, 2012 and 2011. Payment activity is reviewed by management on a monthly basis to determine how loans are performing. Loans are considered to be nonperforming when they become 90 days past due or are placed on nonaccrual.

	2012			
	First Mortgages	Home Equity Loans	Consumer	Total
Performing	$ 130,235	$ 14,173	$ 4,461	$ $ 148,869
Nonperforming	263	5	9	277
Total	$ 130,498	$ 14,178	$ 4,470	$ $ 149,146

	2011			
	First Mortgages	Home Equity Loans	Consumer	Total
Performing	$ 132,916	$ 18,572	$ 4,838	$ $ 156,326
Nonperforming	351	21	-	372
Total	$ 133,267	$ 18,593	$ 4,838	$ $ 156,698

Following are tables which include an aging analysis of the recorded investment of past-due loans as of December 31, 2012 and 2011.

	2012					
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total
Commercial						
Obligations of state and political subdivisions	$ -	$ -	$ -	$ -	$ 20,627	$ 20,627
Other commercial loans	-	315	18	333	31,512	31,845
Commercial real estate						
Loans for investment property	80	93	-	173	19,136	19,309
Other commercial real estate loans	-	-	137	137	20,046	20,183
Residential mortgage loans						
First mortgages	1,635	197	263	2,095	128,403	130,498
Home equity loans	170	33	5	208	13,970	14,178
Consumer	45	10	9	64	4,406	4,470
Total	$ 1,930	$ 648	$ 432	$ 3,010	$ 238,100	$ 241,110

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

	2011					
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total
Commercial						
Obligations of state and political subdivisions	$ -	$ -	$ -	$ -	$ 21,153	$ 21,153
Other commercial loans	86	28	16	130	31,730	31,860
Commercial real estate						
Loans for investment property	119	-	70	189	20,125	20,314
Other commercial real estate loans	-	102	70	172	20,840	21,012
Residential mortgage loans						
First mortgages	1,351	233	197	1,781	131,486	133,267
Home equity loans	180	-	21	201	18,392	18,593
Consumer	33	1	-	34	4,804	4,838
Total	$ 1,769	$ 364	$ 374	$ 2,507	$ 248,530	$ 251,037

Impaired Loans

Management evaluates commercial loans and commercial real estate loans which are 90 days or more past due and considers them to be impaired. Loans rated Substandard or Doubtful are also evaluated for impairment. These loans are analyzed to determine whether it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees, or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired Loans (Continued)

The following tables include the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable, as of and for the years ending December 31:

	2012				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial:					
Obligations of state and political subdivisions	$ -	$ -	$ -	$ -	$ -
Other commercial loans	29	29	-	33	-
Commercial real estate:					
Loans for investment properties	-	-	-	-	-
Other commercial real estate loans	98	98	-	99	-
With an allowance recorded:					
Commercial:					
Obligations of state and political subdivisions	-	-	-	-	-
Other commercial loans	-	-	-	-	-
Commercial real estate:					
Loans for investment properties	-	-	-	-	-
Other commercial real estate loans	-	-	-	-	-
Total	$ 127	$ 127	$ -	$ 132	$ -

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired Loans (Continued)

	2011				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial:					
Obligations of state and political subdivisions	$ -	$ -	$ -	$ -	$ -
Other commercial loans	37	37	-	38	-
Commercial real estate:					
Loans for investment properties	-	-	-	-	-
Other commercial real estate loans	26	26	-	13	2
With an allowance recorded:					
Commercial:					
Obligations of state and political subdivisions	-	-	-	-	-
Other commercial loans	18	18	18	290	1
Commercial real estate:					
Loans for investment properties	-	-	-	33	-
Other commercial real estate loans	75	75	2	37	6
Total	$ 156	$ 156	$ 20	$ 411	$ 9

Nonaccrual Loans

Loans are considered for nonaccrual status upon 90 days delinquency. When a loan is placed in nonaccrual status, previously accrued but unpaid interest is deducted from interest income.

(Amounts in thousands except per share data)

NOTE 4 - ALLOWANCE FOR LOAN LOSSES (Continued)

Nonaccrual Loans (Continued)

The following tables present loans that are on nonaccrual status and that are 90 days delinquent and still accruing interest by portfolio segment as of December 31:

	2012	
	Nonaccrual	Past due 90 days or more and still accruing
Commercial:		
Obligations of state and political subdivisions	$ -	$ -
Other commercial loans	18	-
Commercial real estate:		
Loans for investment properties	-	-
Other commercial real estate loans	137	-
Residential mortgage loans:		
First mortgages	239	24
Home equity loans	5	-
Consumer loans	-	9
	$ 399	$ 33

	2011	
	Nonaccrual	Past due 90 days or more and still accruing
Commercial:		
Obligations of state and political subdivisions	$ -	$ -
Other commercial loans	-	16
Commercial real estate:		
Loans for investment properties	70	-
Other commercial real estate loans	37	33
Residential mortgage loans:		
First mortgages	311	40
Home equity loans	3	18
Consumer loans	-	-
	$ 421	$ 107

Interest income on nonaccrual loans not recognized during 2012 and 2011 was $30,000 and $40,000, respectively.

During the years ended December 31, 2012 and 2011, the Company did not have any loan modifications classified as troubled debt restructurings. During the periods, the Company also did not have any loans classified as a troubled debt restructuring which subsequently defaulted.

(Amounts in thousands except per share data)

NOTE 5 - PREMISES AND EQUIPMENT

Major classifications of premises and equipment are summarized as follows:

	2012	2011
Land and improvements	$ 1,458	$ 1,458
Buildings and improvements	7,827	7,635
Furniture, fixtures, and equipment	3,574	3,431
	12,859	12,524
Less accumulated depreciation	4,295	3,744
Total	$ 8,564	$ 8,780

Depreciation expense for the years ended December 31, 2012 and 2011, was $552,000 and $488,000, respectively.

NOTE 6 - DEPOSITS

Time deposits at December 31, 2012, mature $56,848,000, $30,148,000, $34,215,000, $13,973,000, $7,469,000, and $1,417,000 during 2013, 2014, 2015, 2016, 2017, and 2018 and after, respectively.

Time deposits include certificates of deposit in denominations of $100,000 or more. Such deposits aggregated $58,041,000 and $66,283,000 at December 31, 2012 and 2011, respectively. Maturities on time deposits of $100,000 or more at December 31, 2012, are as follows:

Within three months	$ 3,999
Three through six months	4,553
Six through twelve months	9,210
Over twelve months	40,279
Total	$ 58,041

NOTE 7 - OTHER BORROWINGS

The following table sets forth information concerning other borrowings with the FHLB:

Description	Maturity	Weighted-Average Interest Rate	Stated Interest Rate Range From	Stated Interest Rate Range To	December 31, 2011
Fixed	5/7/2012	7.84%	7.84%	7.84%	$ 72
Convertible	6/6/2012	5.20%	5.20%	5.20%	5,000
					$ 5,072

The Bank maintains a credit arrangement which includes a revolving line of credit with the FHLB. Under this credit arrangement, the Bank has a maximum borrowing capacity of approximately $123.2 million at December 31, 2012, which is subject to annual renewal and typically incurs no service charges. Under terms of a blanket agreement, collateral for the FHLB borrowings must be secured by certain qualifying assets of the Bank that consist principally of first mortgage loans.

(Amounts in thousands except per share data)

NOTE 8 - INCOME TAXES

The provision for income taxes consists of:

	2012	2011
Current	$ 1,526	$ 1,138
Deferred	(129)	289
Total	$ 1,397	$ 1,427

The tax effects of deductible and taxable temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities respectively at December 31 are as follows:

	2012	2011
Deferred tax assets:		
Allowance for loan losses	$ 740	$ 764
Mortgage servicing rights	52	-
Accrued pension obligation	986	915
Other	42	6
Total gross deferred tax assets	1,820	1,685
Deferred tax liabilities:		
Premises and equipment	520	525
Investment accretion	1	4
Unrealized gain on investment securities	1,145	1,060
Prepaid pension costs	345	322
Loan origination fees and costs	59	139
Total gross deferred tax liabilities	2,070	2,050
Net deferred tax liabilities	$ (250)	$ (365)

No valuation allowance was established at December 31, 2012 and 2011, in view of the Company's ability to carryback to taxes paid in previous years and certain tax strategies, coupled with the anticipated future taxable income as evidenced by the Company's earnings potential.

The following is a reconciliation of the federal statutory rate and the Company's effective income tax rate for the years ended December 31:

	2012		2011	
	Amount	% of Pretax Income	Amount	% of Pretax Income
Provision at statutory rate	$ 1,987	34.0 %	$ 1,917	34.0 %
Effect of tax-free income	(634)	(10.8)	(542)	(9.6)
Nondeductible interest expense	44	0.7	49	0.8
Other, net	-	-	3	0.1
Actual tax expense and effective rate	$ 1,397	23.9 %	$ 1,427	25.3 %

NOTE 8 - INCOME TAXES (Continued)

The Company prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

There is currently no liability for uncertain tax positions and no known unrecognized tax benefits. The Company recognizes, when applicable, interest and penalties related to unrecognized tax benefits in the provision for income taxes in the Consolidated Statement of Income. With few exceptions, the Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2008.

NOTE 9 - COMMITMENTS

In the normal course of business, the Company makes various commitments that are not reflected in the accompanying consolidated financial statements. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheet. The Company's exposure to credit loss in the event of nonperformance by the other parties to the financial instruments is represented by the contractual amounts as disclosed. Losses, if any, are charged to the allowance for loan losses. The Company minimizes its exposure to credit loss under these commitments by subjecting them to credit approval, review procedures, and collateral requirements as deemed necessary.

The off-balance sheet commitments consisted of the following:

	2012	2011
Commitments to extend credit	$ 32,413	$ 23,533
Standby letters of credit	3,751	3,596

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. These commitments are composed primarily of available commercial lines of credit and mortgage loan commitments. The Company uses the same credit policies in making loan commitments and conditional obligations as it does for on-balance sheet instruments. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, as deemed necessary, is based upon management's credit evaluation in compliance with the Company's lending policy guidelines. Customers use credit commitments to ensure funds will be available for working capital purposes, for capital expenditures, and to ensure access to funds at specified terms and conditions.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Performance letters of credit represent conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These instruments are issued primarily to support bid- or performance-related contracts. The coverage period for these instruments is typically a one-year period with an annual renewal option subject to prior approval by management. Fees earned from the issuance of these letters are recognized over the coverage period. For secured letters of credit, the collateral is typically Company deposit instruments or customer business assets.

(Amounts in thousands except per share data)

NOTE 10 - PENSION PLAN

The Bank sponsors a defined benefit pension plan covering substantially all employees and officers. The plan calls for benefits to be paid to eligible employees at retirement, based primarily upon years of service with the Bank and compensation rates during employment. The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plan's actuary.

The following table sets forth the obligation and funded status as of December 31:

	2012	2011
Change in benefit obligation		
Benefit obligation at beginning of year	$ 5,966	$ 4,246
Service cost	579	399
Interest cost	264	238
Change in assumptions	480	1,078
Actuarial gains	125	101
Benefits paid	(83)	(96)
Benefit obligation at end of year	7,331	5,966
Change in plan assets		
Fair value of plan assets at beginning of year	4,251	3,801
Adjustment to market value at beginning of year	17	24
Actual return on plan assets	589	22
Employer contribution	700	500
Benefits paid	(83)	(96)
Fair value of plan assets at end of year	5,474	4,251
Funded status	$ (1,857)	$ (1,715)

	2012	2011
Amounts not yet recognized as a component of net periodic pension cost:		
Amounts recognized in accumulated other comprehensive income consists of:		
Net loss	$ 2,900	$ 2,690
Total	$ 2,900	$ 2,690

The accumulated benefit obligation for the defined benefit pension plan was $5,866,000 and $4,722,000 at December 31, 2012 and 2011, respectively.

(Amounts in thousands except per share data)

NOTE 10 - PENSION PLAN (Continued)

Components of Net Periodic Benefit Cost

	2012	2011
Net periodic pension cost:		
Service cost	$ 579	$ 399
Interest cost	264	238
Expected return on plan assets	(340)	(302)
Amortization of net loss	128	56
Net periodic benefit cost	$ 631	$ 391

The estimated net loss for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is $340,000.

Assumptions

The weighted-average assumptions used to determine benefit obligations at December 31:

	2012	2011
Discount rate	4.00 %	4.37 %
Rate of compensation increase	4.25	4.25

The weighted-average assumptions used to determine net periodic benefit cost for the years ended December 31:

	2012	2011
Discount rate	4.37 %	5.52 %
Expected long-term return on plan assets	8.00	8.00
Rate of compensation increase	4.25	4.25

The long-term rate of return on plan assets gives consideration to returns currently being earned on plan assets, as well as future rates expected to be returned.

(Amounts in thousands except per share data)

NOTE 10 - PENSION PLAN (Continued)

Plan Assets

The Bank's defined benefit pension plan weighted-average asset allocations at December 31 by asset category are as follows:

Asset Category	2012	2011
Mutual funds	63.50 %	62.81 %
Corporate bonds	22.18	18.11
U.S. government agency securities	13.70	18.30
Cash and cash equivalents	0.62	0.78
Total	100.00 %	100.00 %

The Bank believes that the plan's risk and liquidity position are, in large part, a function of the asset class mix. The Bank desires to utilize a portfolio mix that results in a balanced investment strategy. The investment objective for the defined benefit pension plan is to maximize total return with tolerance for average to slightly above average risk. Asset allocation strongly favors mutual funds.

The following table sets forth by level, within the fair value hierarchy, the plan's assets at fair value as of December 31, 2012 and 2011:

	December 31, 2012			
	Level I	Level II	Level III	Total
Assets:				
Cash and cash equivalents	$ 34	$ -	$ -	$ 34
U.S. government agency securities	-	750	-	750
Corporate bonds	-	1,214	-	1,214
Mutual funds	3,476	-	-	3,476
Total assets at fair value	$ 3,510	$ 1,964	$ -	$ 5,474

	December 31, 2011			
	Level I	Level II	Level III	Total
Assets:				
Cash and cash equivalents	$ 33	$ -	$ -	$ 33
U.S. government agency securities	-	778	-	778
Corporate bonds	-	770	-	770
Mutual funds	2,670	-	-	2,670
Total assets at fair value	$ 2,703	$ 1,548	$ -	$ 4,251

Cash Flows

The Bank expects to contribute $700,000 to its defined benefit pension plan in 2013.

(Amounts in thousands except per share data)

NOTE 10 - PENSION PLAN (Continued)

Cash Flows (Continued)

The following benefit payments that reflect expected future service, as appropriate, are expected to be paid:

	Pension Benefits
2013	$ 93
2014	95
2015	135
2016	154
2017	207
2018 through 2022	1,549
	$ 2,233

NOTE 11 - REGULATORY MATTERS

Cash and Due from Banks

The district Federal Reserve Bank requires the Bank to maintain certain average reserve balances. As of December 31, 2012 and 2011, the Bank had required reserves of $165,000 and $150,000, respectively.

Loans

Federal law prevents the Company from borrowing from the Bank unless the loans are secured by specific collateral. Further, such secured loans are limited in amount to 10 percent of the Bank's common stock and capital surplus.

Dividends

The Bank is subject to a dividend restriction that generally limits the amount of dividends that can be paid by a national bank. Prior approval of the Office of the Comptroller of the Currency ("OCC") is required if the total of all dividends declared by a national bank in any calendar year exceeds net profits, as defined for the year, combined with its retained net profits for the two preceding calendar years less any required transfers to surplus. Using this formula, the amount available for payment of dividends by the Bank in 2012, without approval of the OCC, is approximately $7,129,000 plus 2013 net profits retained up to the date of the dividend declaration.

Capital Requirements

Federal regulations require the Company and the Bank to maintain minimum amounts of capital. Specifically, each is required to maintain certain minimum dollar amounts and ratios of Total and Tier I capital to risk-weighted assets and of Tier I capital to average total assets.

In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") established five capital categories ranging from "well capitalized" to "critically undercapitalized." Should any institution fail to meet the requirements to be considered "adequately capitalized," it would become subject to a series of increasingly restrictive regulatory actions.

(Amounts in thousands except per share data)

NOTE 11 - REGULATORY MATTERS (Continued)

Capital Requirements (Continued)

As of December 31, 2012 and 2011, the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be classified as a well capitalized financial institution, Total risk-based, Tier I risk-based, and Tier I leverage capital ratios must be at least 10 percent, 6 percent, and 5 percent, respectively.

The Company's actual capital ratios are presented in the following table that shows the Company met all regulatory capital requirements. The capital position of the Bank does not differ significantly from the Company's.

	2012		2011	
	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets)				
Actual	$ 43,845	21.33 %	$ 40,319	20.08 %
For capital adequacy purposes	16,443	8.00	16,062	8.00
To be well capitalized	20,554	10.00	20,077	10.00
Tier I capital (to risk-weighted assets)				
Actual	$ 41,387	20.14 %	$ 37,809	18.83 %
For capital adequacy purposes	8,221	4.00	8,031	4.00
To be well capitalized	12,332	6.00	12,046	6.00
Tier I capital (to average assets)				
Actual	$ 41,387	8.87 %	$ 37,809	8.37 %
For capital adequacy purposes	18,664	4.00	18,073	4.00
To be well capitalized	23,330	5.00	22,591	5.00

NOTE 12 - FAIR VALUE MEASUREMENTS

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value. The three broad levels of pricing observations are as follows:

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level II: Pricing inputs are other than the quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities includes items for which quoted prices are available but traded less frequently and items that are fair-valued using other financial instruments, the parameters of which can be directly observed.

Level III: Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the use of observable market data when available.

(Amounts in thousands except per share data)

NOTE 12 - FAIR VALUE MEASUREMENTS (Continued)

The following tables present the assets reported on the balance sheet at their fair value as of December 31, 2012 and 2011, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	December 31, 2012			
	Level I	Level II	Level III	Total
Assets measured on a recurring basis:				
Investment securities available for sale:				
Obligations of states and political subdivisions	$ -	$ 61,094	$ -	$ 61,094
Mortgage-backed securities in government-sponsored entities	-	126,382	-	126,382
Corporate debt securities	-	742	-	742
Equity securities in financial institutions	138	-	-	138
Total	$ 138	$ 188,218	$ -	$ 188,356

	December 31, 2011			
	Level I	Level II	Level III	Total
Assets measured on a recurring basis:				
Investment securities available for sale:				
U.S. government agency securities	$ -	$ 1,000	$ -	$ 1,000
Obligations of states and political subdivisions	-	52,550	-	52,550
Mortgage-backed securities in government-sponsored entities	-	115,918	-	115,918
Corporate debt securities	-	467	-	467
Equity securities in financial institutions	130	-	-	130
Total	$ 130	$ 169,935	$ -	$ 170,065

(Amounts in thousands except per share data)

NOTE 12 - FAIR VALUE MEASUREMENTS (Continued)

The following table presents the assets measured on a nonrecurring basis on the Consolidated Balance Sheet at their fair value as of December 31, 2012 and 2011, by level within the fair value hierarchy. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loan include: quoted market prices for identical assets classified as Level I inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level II inputs. In cases where valuation techniques included inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance, the asset valuation is classified as Level III inputs. The fair values consist of the loan balances of $127,000 and $156,000 less their valuation allowances of $0 and $20,000 at December 31, 2012 and 2011, respectively.

Other real estate owned ("OREO") is measured at fair value, less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value, less cost to sell.

Mortgage servicing rights are accounted for under the amortization method and are adjusted to the lower of aggregate cost or estimated fair value as appropriate. Fair value is estimated by projecting and discounting future cash flows. Various assumptions including future cash flows, market discount rates, expected prepayment rates, servicing costs, and other factors are used in the valuation of mortgage servicing rights.

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2012 and 2011, are as follows:

	December 31, 2012			
	Level I	Level II	Level III	Total
Fair value measurements on nonrecurring basis:				
Impaired loans	$ -	$ -	$ 127	$ 127
Other real estate owned			86	86
Mortgage servicing rights	-	-	584	584
Total	$ -	$ -	$ 797	$ 797

	December 31, 2011			
	Level I	Level II	Level III	Total
Fair value measurements on nonrecurring basis:				
Impaired loans	$ -	$ -	$ 136	$ 136
Other real estate owned	-	-	102	102
Mortgage servicing rights	-	-	604	604
Total	$ -	$ -	$ 842	$ 842

NOTE 12 - FAIR VALUE MEASUREMENTS (Continued)

The following table provides information describing the valuation processes used to determine nonrcurring fair value measurements categorized within Level III of the fair value hierarchy (in thousands):

	Quantitative Information about Level III Fair Value Measurements					
	Fair Value	Valuation Techniques		Unobservable Input		Range (Weighted Average)
Impaired loans	$ 127	Appraisal of collateral	(1)	Appraisal adjustments	(2)	25%-28% (26%)
				Liquidation Expenses	(2)	7.20%-7.50% (7.35%)
Other real estate owned	86	Appraisal of collateral	(1), (3)			
Mortgage servicing rights	584	Discounted cash flows		Discount rate		10.50%-11.50% (11.01)

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which include various Level III inputs which are not identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions, aging, and/or estimated liquidation expenses incurred when selling the collateral. The range and weighted average of appraisal adjustments and liquidation expenses are presented as a percentage of the appraisal.
(3) Includes qualitative adjustments by management and estimate liquidation expenses.

(Amounts in thousands except per share data)

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair values at December 31 of the Company’s financial instruments are as follows:

	2012				
	Carrying Value	Fair Value	Level I	Level II	Level III
Financial assets:					
Cash and cash equivalents	$ 8,036	$ 8,036	$ 8,036	$ -	$ -
Investment securities:					
Available for sale	188,356	188,356	138	188,218	-
Held to maturity	4,444	4,477	-	4,477	-
Loans held for sale	4,515	4,515	4,515	4,515	-
Net loans	238,652	243,107	-	-	243,107
Regulatory stock	2,216	2,216	2,216	-	-
Bank-owned life insurance	6,146	6,146	6,146	-	-
Mortgage servicing rights	584	584	-	-	584
Accrued interest receivable	1,652	1,652	1,652	-	-
Financial liabilities:					
Deposits	$ 420,094	$ 423,977	$ 276,024	$ -	$ 147,953
Accrued interest payable	180	180	180	-	-

	2011	
	Carrying Value	Fair Value
Financial assets:		
Cash and cash equivalents	$ 12,713	$ 12,713
Investment securities:		
Available for sale	170,065	170,065
Held to maturity	4,099	4,149
Loans held for sale	1,166	1,166
Net loans	248,499	254,077
Regulatory stock	2,025	2,025
Mortgage servicing rights	604	604
Accrued interest receivable	1,605	1,605
Financial liabilities:		
Deposits	$ 405,103	$ 409,649
Other borrowings	5,072	5,177
Accrued interest payable	246	246

Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract that creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. If a quoted market price is available for a financial instrument, the estimated fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value estimates for financial instruments should be based upon management's judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses, and other factors as determined through various option pricing formulas. As many of these assumptions result from judgments made by management based upon estimates that are inherently uncertain, the resulting estimated fair values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in assumptions on which the estimated fair values are based may have a significant impact on the resulting estimated fair values.

As certain assets, such as deferred tax assets and premises and equipment, are not considered financial instruments, the estimated fair value of financial instruments would not represent the full value of the Company.

The Company employed simulation modeling in determining the estimated fair value of financial instruments for which quoted market prices were not available based upon the following assumptions:

Cash and Cash Equivalents, Loans Held for Sale, Regulatory Stock, Accrued Interest Receivable, and Accrued Interest Payable

The fair value is equal to the current carrying value.

Investment Securities

The fair market value of investment securities is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities. Fair values for certain corporate bonds were determined utilizing discounted cash flow models, due to the absence of a current market to provide reliable market quotes for the instruments.

Loans

Fair value is estimated by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality. Where quoted market prices were available, primarily for certain residential mortgage loans, such market rates were utilized as estimates for fair value.

Bank-Owned Life Insurance

The fair value is equal to the cash surrender value of the life insurance policies.

Mortgage Servicing Rights

The fair value for mortgage servicing rights is estimated by discounting contractual cash flows and adjusting for prepayment estimates. Discount rates are based upon rates generally charged for such loans with similar characteristics.

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Deposits and Other Borrowings

The fair values of certificates of deposit and other borrowed funds are based on the discounted value of contractual cash flows. The discount rates are estimated using rates currently offered for similar instruments with similar remaining maturities. Demand, savings, and money market deposit accounts are valued at the amount payable on demand as of year-end.

Commitments to Extend Credit and Commercial Letters of Credit

These financial instruments are generally not subject to sale, and estimated fair values are not readily available.

The carrying value, represented by the net deferred fee arising from the unrecognized commitment or letter of credit, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar credit risk, are not considered material for disclosure. The contractual amounts of unfunded commitments and letters of credit are presented in Note 9.

NOTE 14 - SUBSEQUENT EVENTS

Management has reviewed events occurring through March 28, 2013, the date the financial statements were issued and no subsequent events occurred requiring accrual or disclosure.