LAKELAND FINANCIAL CORP
Form 10-Q
November 07, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

# FORM 10-Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

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

**OR**

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from ____________ to _____________**

**LAKELAND FINANCIAL CORPORATION**

**(Exact name of registrant as specified in its charter)**

| | | |
|---|---|---|
| Indiana | 0-11487 | 35-1559596 |
| (State or Other Jurisdiction of Incorporation or Organization) | (Commission File Number) | (IRS Employer Identification No.) |

**202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581-1387**

**(Address of Principal Executive Offices)(Zip Code)**

**(574) 267-6144**

**Registrant's Telephone Number, Including Area Code**

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

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

Large accelerated filer ¨ Accelerated filer x 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 x

Number of shares of common stock outstanding at October 31, 2012: 16,346,247

**LAKELAND FINANCIAL CORPORATION**

**Form 10-Q Quarterly Report**

**Table of Contents**

PART I.



PART II.

**PART 1**

**LAKELAND FINANCIAL CORPORATION**

**ITEM 1 – FINANCIAL STATEMENTS**

**LAKELAND FINANCIAL CORPORATION**

**CONSOLIDATED BALANCE SHEETS**

**As of September 30, 2012 and December 31, 2011**

**(in thousands except for share data)**

**(Page 1 of 2)**

| | **September 30, 2012** (Unaudited) | December 31, 2011 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $ 134,785 | $ 56,909 |
| Short-term investments | 46,617 | 47,675 |
| Total cash and cash equivalents | 181,402 | 104,584 |
| | | |
| Securities available for sale (carried at fair value) | 481,256 | 467,391 |
| Real estate mortgage loans held for sale | 6,707 | 2,953 |
| | | |
| Loans, net of allowance for loan losses of $51,912 and $53,400 | 2,151,476 | 2,180,309 |
| | | |
| Land, premises and equipment, net | 34,969 | 34,736 |
| Bank owned life insurance | 40,848 | 39,959 |
| Accrued income receivable | 9,735 | 9,612 |
| Goodwill | 4,970 | 4,970 |
| Other intangible assets | 60 | 99 |
| Other assets | 40,785 | 45,075 |
| Total assets | $ 2,952,208 | $ 2,889,688 |

(continued)

1

**LAKELAND FINANCIAL CORPORATION**

**CONSOLIDATED BALANCE SHEETS**

**As of September 30, 2012 and December 31, 2011**

**(in thousands except for share data)**

**(Page 2 of 2)**

| | September 30, 2012 (Unaudited) | December 31, 2011 |
|---|---|---|
| LIABILITIES AND EQUITY | | |
| | | |
| LIABILITIES | | |
| Noninterest bearing deposits | $ 357,531 | $ 356,682 |
| Interest bearing deposits | 2,118,566 | 2,056,014 |
| Total deposits | 2,476,097 | 2,412,696 |
| | | |
| Short-term borrowings | | |
| Federal funds purchased | 0 | 10,000 |
| Securities sold under agreements to repurchase | 118,552 | 131,990 |
| Total short-term borrowings | 118,552 | 141,990 |
| | | |
| Accrued expenses payable | 15,414 | 13,550 |
| Other liabilities | 1,189 | 2,195 |
| Long-term borrowings | 15,038 | 15,040 |
| Subordinated debentures | 30,928 | 30,928 |
| Total liabilities | 2,657,218 | 2,616,399 |
| | | |
| EQUITY | | |
| Common stock: 90,000,000 shares authorized, no par value | | |
| 16,346,247 shares issued and 16,260,259 outstanding as of September 30, 2012 | | |
| 16,217,019 shares issued and 16,145,772 outstanding as of December 31, 2011 | 89,255 | 87,380 |
| Retained earnings | 200,615 | 181,903 |
| Accumulated other comprehensive income | 6,644 | 5,139 |
| Treasury stock, at cost (2012 - 85,988 shares, 2011 - 71,247 shares) | (1,613 ) | (1,222 ) |
| Total stockholders' equity | 294,901 | 273,200 |
| | | |
| Noncontrolling interest | 89 | 89 |
| Total equity | 294,990 | 273,289 |
| Total liabilities and equity | $ 2,952,208 | $ 2,889,688 |

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

2

**LAKELAND FINANCIAL CORPORATION**

**CONSOLIDATED STATEMENTS OF INCOME**

**For the Three Months and Nine Months Ended September 30, 2012 and 2011**

**(in thousands except for share and per share data)**

**(Unaudited)**

**(Page 1 of 2)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| NET INTEREST INCOME | | | | |
| Interest and fees on loans | | | | |
| Taxable | $ 25,803 | $ 26,390 | $ 77,789 | $ 78,555 |
| Tax exempt | 109 | 114 | 333 | 357 |
| Interest and dividends on securities | | | | |
| Taxable | 2,034 | 3,217 | 7,425 | 10,635 |
| Tax exempt | 698 | 692 | 2,094 | 2,068 |
| Interest on short-term investments | 16 | 18 | 43 | 114 |
| Total interest income | 28,660 | 30,431 | 87,684 | 91,729 |
| Interest on deposits | 5,989 | 7,090 | 19,352 | 20,868 |
| Interest on borrowings | | | | |
| Short-term | 112 | 159 | 329 | 477 |
| Long-term | 399 | 361 | 1,198 | 1,084 |
| Total interest expense | 6,500 | 7,610 | 20,879 | 22,429 |
| NET INTEREST INCOME | 22,160 | 22,821 | 66,805 | 69,300 |
| Provision for loan losses | 0 | 2,400 | 1,299 | 10,900 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 22,160 | 20,421 | 65,506 | 58,400 |
| NONINTEREST INCOME | | | | |
| Wealth advisory fees | 959 | 866 | 2,770 | 2,613 |
| Investment brokerage fees | 695 | 741 | 2,435 | 2,093 |
| Service charges on deposit accounts | 2,045 | 2,036 | 5,937 | 5,938 |
| Loan, insurance and service fees | 1,421 | 1,259 | 4,062 | 3,595 |

| | | | | |
|---|---|---|---|---|
| Merchant card fee income | 297 | 253 | 902 | 775 |
| Other income | 669 | 362 | 1,614 | 1,380 |
| Mortgage banking income | 590 | 440 | 1,574 | 594 |
| Net securities losses | (380 ) | (1 ) | (377 ) | (167 ) |
| Other than temporary impairment loss on available-for-sale securities: | | | | |
| Total impairment losses recognized on securities | (67 ) | (33 ) | (1,052 ) | (154 ) |
| Loss recognized in other comprehensive income | 0 | 0 | 26 | 0 |
| Net impairment loss recognized in earnings | (67 ) | (33 ) | (1,026 ) | (154 ) |
| Total noninterest income | 6,229 | 5,923 | 17,891 | 16,667 |

(continued)

3

**LAKELAND FINANCIAL CORPORATION**

**CONSOLIDATED STATEMENTS OF INCOME**

**For the Three Months and Nine Months Ended September 30, 2012 and 2011**

**(in thousands except for share and per share data)**

**(Unaudited)**

**(Page 2 of 2)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| NONINTEREST EXPENSE | | | | |
| Salaries and employee benefits | 8,569 | 8,611 | 26,007 | 24,802 |
| Net occupancy expense | 803 | 746 | 2,519 | 2,373 |
| Equipment costs | 641 | 536 | 1,854 | 1,600 |
| Data processing fees and supplies | 1,143 | 729 | 3,044 | 2,820 |
| Other expense | 3,146 | 2,857 | 9,807 | 10,025 |
| Total noninterest expense | 14,302 | 13,479 | 43,231 | 41,620 |
| INCOME BEFORE INCOME TAX EXPENSE | 14,087 | 12,865 | 40,166 | 33,447 |
| Income tax expense | 4,740 | 4,418 | 13,374 | 11,046 |
| NET INCOME | $9,347 | $8,447 | $26,792 | $22,401 |
| BASIC WEIGHTED AVERAGE COMMON SHARES | 16,340,425 | 16,208,889 | 16,312,896 | 16,201,900 |
| BASIC EARNINGS PER COMMON SHARE | $0.57 | $0.52 | $1.64 | $1.38 |
| DILUTED WEIGHTED AVERAGE COMMON SHARES | 16,490,390 | 16,324,058 | 16,470,485 | 16,309,814 |
| DILUTED EARNINGS PER COMMON SHARE | $0.57 | $0.52 | $1.63 | $1.37 |

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

4

**LAKELAND FINANCIAL CORPORATION**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**For the Three Months and Nine Months Ended September 30, 2012 and 2011**

**(in thousands)**

**(Unaudited)**

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net income | $ 9,347 | $ 8,447 | $ 26,792 | $ 22,401 |
| Other comprehensive income | | | | |
| Change in securities available for sale: | | | | |
| Unrealized holding gain (loss) on securities available for sale arising during the period | (251) | 4,857 | 818 | 8,651 |
| Reclassification adjustment for losses included in net income | 380 | 1 | 377 | 167 |
| Reclassification adjustment for other than temporary impairment | 67 | 33 | 1,026 | 154 |
| Net securities gain activity during the period | 196 | 4,891 | 2,221 | 8,972 |
| Tax effect | (76) | (1,889) | (880) | (3,462) |
| Net of tax amount | 120 | 3,002 | 1,341 | 5,510 |
| Defined benefit pension plans: | | | | |
| Net gain(loss) on defined benefit pension plans | 0 | 0 | 110 | (233) |
| Amortization of net actuarial loss | 55 | 62 | 164 | 132 |
| Net gain /(loss) activity during the period | 55 | 62 | 274 | (101) |
| Tax effect | (22) | (26) | (110) | 41 |
| Net of tax amount | 33 | 36 | 164 | (60) |
| Total other comprehensive income, net of tax | 153 | 3,038 | 1,505 | 5,450 |
| Comprehensive income | $ 9,500 | $ 11,485 | $ 28,297 | $ 27,851 |

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

**LAKELAND FINANCIAL CORPORATION**

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

**For the Nine Months Ended September 30, 2012 and 2011**

**(in thousands except for share and per share data)**

**(Unaudited)**

| | Common Stock | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total Stockholders' Equity |
|---|---|---|---|---|---|
| Balance at January 1, 2011 | $ 85,766 | $ 161,299 | $ 1,350 | $ (1,418 ) | $ 246,997 |
| Comprehensive income: | | | | | |
| Net income | | 22,401 | | | 22,401 |
| Other comprehensive income (loss), net of tax | | | 5,450 | | 5,450 |
| Comprehensive income | | | | | 27,851 |
| Common stock cash dividends declared, $0.465 per share | | (7,546 ) | | | (7,546 ) |
| Treasury shares purchased under deferred directors' plan (10,187 shares) | 233 | | | (233 ) | 0 |
| Treasury shares sold under deferred directors' plan (30,100 shares) | (440 ) | | | 440 | 0 |
| Stock activity under stock compensation plans (42,200 shares) | 395 | | | | 395 |
| Stock compensation expense | 1,061 | | | | 1,061 |
| Balance at September 30, 2011 | $ 87,015 | $ 176,154 | $ 6,800 | $ (1,211 ) | $ 268,758 |
| | | | | | |
| Balance at January 1, 2012 | $ 87,380 | $ 181,903 | $ 5,139 | $ (1,222 ) | $ 273,200 |
| Comprehensive income: | | | | | |
| Net income | | 26,792 | | | 26,792 |
| Other comprehensive income (loss), net of tax | | | 1,505 | | 1,505 |
| Comprehensive income | | | | | 28,297 |
| Common stock cash dividends declared, $0.495 per share | | (8,080 ) | | | (8,080 ) |
| Treasury shares purchased under deferred directors' plan (14,741 shares) | 391 | | | (391 ) | 0 |
| Stock activity under stock compensation plans, net of taxes (129,228 shares) | 323 | | | | 323 |
| Stock compensation expense | 1,161 | | | | 1,161 |
| Balance at September 30, 2012 | $ 89,255 | $ 200,615 | $ 6,644 | $ (1,613 ) | $ 294,901 |

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

**LAKELAND FINANCIAL CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For the Nine Months Ended September 30, 2012 and 2011**

**(in thousands)**

**(Unaudited)**

**(Page 1 of 2)**

| | 2012 | 2011 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $26,792 | $22,401 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation | 2,029 | 1,660 |
| Provision for loan losses | 1,299 | 10,900 |
| Loss on sale and write down of other real estate owned | 214 | 358 |
| Amortization of intangible assets | 39 | 41 |
| Amortization of loan servicing rights | 541 | 427 |
| Net change in loan servicing rights valuation allowance | 84 | 162 |
| Loans originated for sale | (89,595) | (48,294) |
| Net gain on sales of loans | (1,926) | (1,004) |
| Proceeds from sale of loans | 87,180 | 49,086 |
| Net loss on sales of premises and equipment | 4 | 17 |
| Net loss on sales and calls of securities available for sale | 377 | 167 |
| Impairment on available for sale securities | 1,026 | 154 |
| Net securities amortization | 5,210 | 2,255 |
| Stock compensation expense | 1,161 | 1,061 |
| Earnings on life insurance | (708) | (726) |
| Tax benefit of stock option exercises | (535) | (96) |
| Net change: | | |
| Accrued income receivable | (123) | 179 |
| Accrued expenses payable | 2,027 | 1,259 |
| Other assets | 2,322 | (1,565) |
| Other liabilities | (615) | (192) |
| Total adjustments | 10,011 | 15,849 |
| Net cash from operating activities | 36,803 | 38,250 |
| | | |
| Cash flows from investing activities: | | |
| Proceeds from sale of securities available for sale | 27,492 | 73,318 |
| Proceeds from maturities, calls and principal paydowns of securities available for sale | 82,499 | 58,668 |
| Purchases of securities available for sale | (128,249) | (147,042) |
| Purchase of life insurance | (210) | (162) |
| Net (increase) decrease in total loans | 27,238 | (95,690) |

| | | |
|---|---|---|
| Proceeds from sales of land, premises and equipment | 2 | 33 |
| Purchases of land, premises and equipment | (2,268) | (2,965) |
| Proceeds from sales of other real estate | 1,698 | 1,254 |
| Net cash from investing activities | 8,202 | (112,586) |

(Continued)

**LAKELAND FINANCIAL CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For the Nine Months Ended September 30, 2012 and 2011**

**(in thousands)**

**(Unaudited)**

**(Page 2 of 2)**

| | 2012 | 2011 |
|---|---|---|
| Cash flows from financing activities: | | |
| Net increase in total deposits | 63,401 | 155,334 |
| Net decrease in short-term borrowings | (23,438 ) | (32,476 ) |
| Payments on long-term borrowings | (2 ) | (1 ) |
| Common dividends paid | (8,067 ) | (7,533 ) |
| Preferred dividends paid | (13 ) | (13 ) |
| Proceeds from stock option exercise | 323 | 395 |
| Purchase of treasury stock | (391 ) | (233 ) |
| Net cash from financing activities | 31,813 | 115,473 |
| Net change in cash and cash equivalents | 76,818 | 41,137 |
| Cash and cash equivalents at beginning of the period | 104,584 | 60,141 |
| Cash and cash equivalents at end of the period | $181,402 | $101,278 |
| Cash paid during the period for: | | |
| Interest | $19,937 | $22,095 |
| Income taxes | 11,028 | 14,629 |
| Supplemental non-cash disclosures: | | |
| Loans transferred to other real estate | 296 | 807 |

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

**LAKELAND FINANCIAL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2012**

**(Table amounts in thousands except for share and per share data)**

**(Unaudited)**

## NOTE 1. BASIS OF PRESENTATION

This report is filed for Lakeland Financial Corporation (the “Company”) and its wholly owned subsidiary, Lake City Bank (the “Bank”). All significant inter-company balances and transactions have been eliminated in consolidation. Also included is the Bank’s wholly owned subsidiary, LCB Investments II, Inc. (“LCB Investments”). LCB Investments also owns LCB Funding, Inc. (“LCB Funding”), a real estate investment trust.

The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and are unaudited. In the opinion of management, all adjustments (all of which are normal and recurring in nature) considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ending September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The 2011 Lakeland Financial Corporation Annual Report on Form 10-K should be read in conjunction with these statements.

## NOTE 2. EARNINGS PER SHARE

Basic earnings per common share is net income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options, stock awards and warrants.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| --- | --- | --- | --- | --- |
| | 2012 | 2011 | 2012 | 2011 |
| Weighted average shares outstanding for basic earnings per common share | 16,340,425 | 16,208,889 | 16,312,896 | 16,201,900 |
| Dilutive effect of stock options, awards and warrants | 149,965 | 115,169 | 157,589 | 107,914 |
| Weighted average shares outstanding for diluted earnings per common share | 16,490,390 | 16,324,058 | 16,470,485 | 16,309,814 |
| | | | | |
| Basic earnings per common share | $ 0.57 | $ 0.52 | $ 1.64 | $ 1.38 |
| Diluted earnings per common share | $ 0.57 | $ 0.52 | $ 1.63 | $ 1.37 |

9

Stock options for 0 and 70,000 shares for both the three-month and nine-month periods ended September 30, 2012 and 2011, respectively, were not considered in computing diluted earnings per common share because they were antidilutive.

**NOTE 3. LOANS**

| | September 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| Commercial and industrial loans: | | | | |
| Working capital lines of credit loans | $445,981 | 20.2 % | $373,768 | 16.7 % |
| Non-working capital loans | 382,850 | 17.4 | 377,388 | 16.9 |
| Total commercial and industrial loans | 828,831 | 37.6 | 751,156 | 33.6 |
| | | | | |
| Commercial real estate and multi-family residential loans: | | | | |
| Construction and land development loans | 87,949 | 4.0 | 82,284 | 3.7 |
| Owner occupied loans | 363,673 | 16.5 | 346,669 | 15.5 |
| Nonowner occupied loans | 308,146 | 14.0 | 385,090 | 17.2 |
| Multifamily loans | 25,482 | 1.2 | 38,477 | 1.7 |
| Total commercial real estate and multi-family residential loans | 785,250 | 35.6 | 852,520 | 38.2 |
| | | | | |
| Agri-business and agricultural loans: | | | | |
| Loans secured by farmland | 119,524 | 5.4 | 118,224 | 5.3 |
| Loans for agricultural production | 94,563 | 4.3 | 119,705 | 5.4 |
| Total agri-business and agricultural loans | 214,087 | 9.7 | 237,929 | 10.7 |
| | | | | |
| Other commercial loans | 44,982 | 2.0 | 58,278 | 2.6 |
| Total commercial loans | 1,873,150 | 85.0 | 1,899,883 | 85.0 |
| | | | | |
| Consumer 1-4 family mortgage loans: | | | | |
| Closed end first mortgage loans | 106,147 | 4.8 | 106,999 | 4.8 |
| Open end and junior lien loans | 168,507 | 7.6 | 175,694 | 7.9 |
| Residential construction and land development loans | 11,303 | 0.5 | 5,462 | 0.2 |
| Total consumer 1-4 family mortgage loans | 285,957 | 13.0 | 288,155 | 12.9 |
| | | | | |
| Other consumer loans | 44,691 | 2.0 | 45,999 | 2.1 |
| Total consumer loans | 330,648 | 15.0 | 334,154 | 15.0 |
| Subtotal | 2,203,798 | 100.0% | 2,234,037 | 100.0% |
| Less: Allowance for loan losses | (51,912 ) | | (53,400 ) | |
| Net deferred loan fees | (410 ) | | (328 ) | |
| Loans, net | $2,151,476 | | $2,180,309 | |

**NOTE 4. ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY**

The following table presents the activity in the allowance for loan losses by portfolio segment for the three-month and nine-month periods ended September 30, 2012, and the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2012:

| | Commercial and Industrial | Commercial Real Estate and Multifamily Residential | Agri-business and Agricultural | Other Commercial | Consumer 1-4 Family Mortgage | Other Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Three Months Ended September 30, 2012 | (in thousands) | | | | | | | |
| Balance July 1, | $ 19,696 | $ 24,083 | $ 1,419 | $ 176 | $ 2,412 | $ 523 | $ 3,508 | $ 51,817 |
| Provision for loan losses | 1,532 | (1,236 ) | (76 ) | (207 ) | 356 | 114 | (483 ) | 0 |
| Loans charged-off | (98 ) | (112 ) | 0 | 0 | (196 ) | (77 ) | 0 | (483 ) |
| Recoveries | 224 | 120 | 1 | 182 | 21 | 30 | 0 | 578 |
| Net loans charged-off | 126 | 8 | 1 | 182 | (175 ) | (47 ) | 0 | 95 |
| Balance September 30, | $ 21,354 | $ 22,855 | $ 1,344 | $ 151 | $ 2,593 | $ 590 | $ 3,025 | $ 51,912 |
| Nine Months Ended September 30, 2012 | | | | | | | | |
| Balance January 1, | $ 22,830 | $ 23,489 | $ 695 | $ 65 | $ 2,322 | $ 645 | $ 3,354 | $ 53,400 |
| Provision for loan losses | 380 | 158 | 648 | (100 ) | 417 | 125 | (329 ) | 1,299 |
| Loans charged-off | (2,552 ) | (959 ) | 0 | 0 | (288 ) | (268 ) | 0 | (4,067 ) |
| Recoveries | 696 | 167 | 1 | 186 | 142 | 88 | 0 | 1,280 |
| Net loans charged-off | (1,856 ) | (792 ) | 1 | 186 | (146 ) | (180 ) | 0 | (2,787 ) |
| Balance September 30, | $ 21,354 | $ 22,855 | $ 1,344 | $ 151 | $ 2,593 | $ 590 | $ 3,025 | $ 51,912 |

Allowance for loan losses:

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Ending allowance balance attributable to loans: | | | | | | | | |
| Individually evaluated for impairment | $6,571 | $ 8,869 | $ 67 | $ 0 | $ 459 | $ 18 | $ 0 | $ 15,984 |
| Collectively evaluated for impairment | 14,783 | 13,986 | 1,277 | 151 | 2,134 | 572 | 3,025 | 35,928 |
| Total ending allowance balance | $21,354 | $ 22,855 | $ 1,344 | $ 151 | $ 2,593 | $ 590 | $ 3,025 | $ 51,912 |
| Loans: | | | | | | | | |
| Loans individually evaluated for impairment | $20,319 | $ 37,924 | $ 820 | $ 0 | $ 2,194 | $ 46 | $ 0 | $ 61,303 |
| Loans collectively evaluated for impairment | 808,700 | 746,439 | 213,350 | 44,974 | 284,027 | 44,595 | 0 | 2,142,085 |
| Total ending loans balance | $829,019 | $ 784,363 | $ 214,170 | $ 44,974 | $ 286,221 | $ 44,641 | $ 0 | $ 2,203,388 |

The recorded investment in loans does not include accrued interest.

The following table presents the activity in the allowance for loan losses by portfolio segment for the three-month and nine-month periods ended September 30, 2011:

| | Commercial and Industrial | Commercial Real Estate and Multifamily Residential | Agri-business and Agricultural | Other Commercial | Consumer 1-4 Family Mortgage | Other Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| | (in thousands) | | | | | | | |
| Three Months Ended September 30, 2011 | | | | | | | | |
| Balance July 1, | $22,999 | $ 20,032 | $ 948 | $ 560 | $ 2,658 | $ 605 | $ 3,458 | $51,260 |
| Provision for loan losses | 1,171 | 2,134 | (194) | (536) | (272) | 294 | (197) | 2,400 |
| Loans charged-off | (883) | (557) | (103) | 0 | (292) | (264) | 0 | (2,099) |
| Recoveries | 465 | 10 | 0 | 0 | 5 | 32 | 0 | 512 |
| Net loans charged-off | (418) | (547) | (103) | 0 | (287) | (232) | 0 | (1,587) |
| Balance September 30, | $23,752 | $ 21,619 | $ 651 | $ 24 | $ 2,099 | $ 667 | $ 3,261 | $52,073 |
| Nine Months Ended September 30, 2011 | | | | | | | | |
| Balance January 1, | $21,479 | $ 15,893 | $ 1,318 | $ 270 | $ 1,694 | $ 682 | $ 3,671 | $45,007 |
| Provision for loan losses | 3,048 | 7,362 | (564) | (246) | 1,390 | 320 | (410) | 10,900 |
| Loans charged-off | (1,470) | (1,973) | (103) | 0 | (1,009) | (493) | 0 | (5,048) |
| Recoveries | 695 | 337 | 0 | 0 | 24 | 158 | 0 | 1,214 |
| Net loans charged-off | (775) | (1,636) | (103) | 0 | (985) | (335) | 0 | (3,834) |
| Balance September 30, | $23,752 | $ 21,619 | $ 651 | $ 24 | $ 2,099 | $ 667 | $ 3,261 | $52,073 |

The recorded investment in loans does not include accrued interest.

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ended December 31, 2011 and 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, 2011:

| | Commercial and Industrial | Commercial Real Estate and Multifamily Residential | Agri-business and Agricultural | Other Commercial | Consumer 1-4 Family Mortgage | Other Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| | (in thousands) | | | | | | | |
| Balance January 1 | $21,479 | $ 15,893 | $ 1,318 | $ 270 | $ 1,694 | $ 682 | $ 3,671 | $ 45,007 |
| Provision for loan losses | 3,112 | 9,748 | (520 ) | (205 ) | 1,632 | 350 | (317 ) | 13,800 |
| Loans charged-off | (2,587 ) | (2,514 ) | (103 ) | 0 | (1,050 ) | (575 ) | 0 | (6,829 ) |
| Recoveries | 826 | 362 | 0 | 0 | 46 | 188 | 0 | 1,422 |
| Net loans charged-off | (1,761 ) | (2,152 ) | (103 ) | 0 | (1,004 ) | (387 ) | 0 | (5,407 ) |
| Balance December 31 | $22,830 | $ 23,489 | $ 695 | $ 65 | $ 2,322 | $ 645 | $ 3,354 | $ 53,400 |
| | | | | | | | | |
| Allowance for loan losses: | | | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | | | |
| Individually evaluated for impairment | $9,443 | $ 8,382 | $ 213 | $ - | $ 288 | $ 0 | $ 0 | $ 18,326 |
| Collectively evaluated for impairment | 13,387 | 15,107 | 482 | 65 | 2,034 | 645 | 3,354 | 35,074 |
| | | | | | | | | |
| Total ending allowance balance | $22,830 | $ 23,489 | $ 695 | $ 65 | $ 2,322 | $ 645 | $ 3,354 | $ 53,400 |
| | | | | | | | | |
| Loans: | | | | | | | | |
| Loans individually evaluated for impairment | $24,204 | $ 35,794 | $ 853 | $ 0 | $ 2,665 | $ 0 | $ 0 | $ 63,516 |
| Loans collectively evaluated for impairment | 727,160 | 815,883 | 237,150 | 58,249 | 285,791 | 45,960 | 0 | 2,170,193 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total ending loans balance | $751,364 | $ 851,677 | $ 238,003 | $ 58,249 | $288,456 | $45,960 | $ 0 | $2,233,709 |

The recorded investment in loans does not include accrued interest.

The allowance for loan losses to total loans at September 30, 2012 and 2011 was 2.36% and 2.39%, respectively. The allowance for loan losses to total loans at December 31, 2011 was 2.39%.

13

The following table presents loans individually evaluated for impairment as of and for the three-month and nine-month periods ended September 30, 2012 and 2011:

| | | | | Three Months Ended September 30, 2012 | | | Nine Months Ended September 30, 201 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated | Average Recorded Investment | Interest Income Recognized | Cash Basis Interest Income Recognized | Average Recorded Investment | Interest Income Recognized | Cash Basis Interest Income Recognized |
| With no related allowance recorded: | | | | | | | | | |
| Commercial and industrial loans: | | | | | | | | | |
| Non-working capital loans | $ 70 | $ 70 | $ 0 | $ 70 | $ 0 | $ 0 | $ 136 | $ 0 | $ 0 |
| Commercial real estate and multi-family residential loans: | | | | | | | | | |
| Owner occupied loans | 781 | 601 | 0 | 611 | 0 | 0 | 513 | 0 | 0 |
| Nonowner occupied loans | 385 | 385 | 0 | 385 | 10 | 13 | 217 | 10 | 13 |
| Agri-business and agricultural loans: | | | | | | | | | |
| Loans secured by farmland | 666 | 487 | 0 | 489 | 0 | 0 | 252 | 0 | 0 |
| Loans for ag production | 0 | 0 | 0 | 0 | 0 | 0 | 68 | 0 | 0 |
| Consumer 1-4 family loans: | | | | | | | | | |
| Closed end first mortgage loans | 277 | 276 | 0 | 417 | 1 | 0 | 432 | 1 | 0 |
| Open end and junior lien loans | 0 | 0 | 0 | 0 | 0 | 0 | 20 | 0 | 0 |
| Other consumer loans | 1 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| With an allowance recorded: | | | | | | | | | |
| Commercial and industrial loans: | | | | | | | | | |
| | 5,915 | 3,074 | 1,417 | 3,059 | 13 | 10 | 4,420 | 42 | 38 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Working capital lines of credit loans | | | | | | | | | |
| Non-working capital loans | 19,357 | 17,175 | 5,154 | 17,072 | 171 | 168 | 17,353 | 528 | 528 |
| Commercial real estate and multi-family residential loans: | | | | | | | | | |
| Construction and land development loans | 3,786 | 3,396 | 672 | 2,436 | 18 | 13 | 1,814 | 35 | 30 |
| Owner occupied loans | 6,900 | 6,287 | 1,527 | 5,702 | 30 | 19 | 4,859 | 48 | 35 |
| Nonowner occupied loans | 27,957 | 27,255 | 6,670 | 27,382 | 78 | 77 | 28,115 | 280 | 281 |
| Agri-business and agricultural loans: | | | | | | | | | |
| Loans secured by farmland | 654 | 333 | 67 | 343 | 0 | 0 | 437 | 0 | 0 |
| Loans for agricultural production | 0 | 0 | 0 | 63 | 0 | 0 | 91 | 0 | 0 |
| Other commercial loans | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Consumer 1-4 family mortgage loans: | | | | | | | | | |
| Closed end first mortgage loans | 1,562 | 1,564 | 267 | 1,730 | 12 | 10 | 1,787 | 32 | 32 |
| Open end and junior lien loans | 354 | 354 | 192 | 353 | 0 | 0 | 340 | 0 | 0 |
| Other consumer loans | 45 | 45 | 18 | 30 | 1 | 1 | 14 | 1 | 1 |
| Total | $ 68,710 | $ 61,303 | $ 15,984 | $ 60,142 | $ 334 | $ 311 | $ 60,868 | $ 977 | $ 958 |

14

The recorded investment in loans does not include accrued interest.

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2011:

| | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated | Average Recorded Investment | Interest Income Recognized | Cash Basis Interest Income Recognized |
|---|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | | |
| Commercial and industrial loans: | | | | | | |
| Non-working capital loans | $ 116 | $ 116 | $ 0 | $ 30 | $ 0 | $ 0 |
| Commercial real estate and multi-family residential loans: | | | | | | |
| Nonowner occupied loans | 0 | 0 | 0 | 425 | 0 | 0 |
| With an allowance recorded: | | | | | | |
| Commercial and industrial loans: | | | | | | |
| Working capital lines of credit loans | 7,831 | 5,969 | 3,206 | 5,649 | 23 | 25 |
| Non-working capital loans | 20,867 | 18,119 | 6,237 | 17,202 | 616 | 625 |
| Commercial real estate and multi-family residential loans: | | | | | | |
| Construction and land development loans | 816 | 429 | 125 | 1,319 | 0 | 0 |
| Owner occupied loans | 5,874 | 5,082 | 1,566 | 3,082 | 41 | 45 |
| Nonowner occupied loans | 30,769 | 30,283 | 6,691 | 24,108 | 246 | 252 |
| Multifamily loans | 0 | 0 | 0 | 0 | 0 | 0 |
| Agri-business and agricultural loans: | | | | | | |
| Loans secured by farmland | 1,126 | 628 | 195 | 610 | 0 | 0 |
| Loans for agricultural production | 225 | 225 | 18 | 410 | 0 | 0 |
| Other commercial loans | 0 | 0 | 0 | 129 | 0 | 0 |
| Consumer 1-4 family mortgage loans: | | | | | | |
| Closed end first mortgage loans | 2,461 | 2,256 | 285 | 1,872 | 44 | 48 |
| Open end and junior lien loans | 409 | 409 | 3 | 118 | 0 | 0 |
| Residential construction loans | 0 | 0 | 0 | 0 | 0 | 0 |
| Other consumer loans | 0 | 0 | 0 | 0 | 0 | 0 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total | $ 70,494 | $ 63,516 | $ 18,326 | $ 54,954 | $ 970 | $ 995 |

The recorded investment in loans does not include accrued interest.

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of September 30, 2012 and December 31, 2011:

| | September 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Nonaccrual | Loans Past Due Over 90 Days Still Accruing | Nonaccrual | Loans Past Due Over 90 Days Still Accruing |
| Commercial and industrial loans: | | | | |
| Working capital lines of credit loans | $ 2,012 | $ 0 | $ 4,743 | $ 0 |
| Non-working capital loans | 5,349 | 0 | 5,433 | 0 |
| Commercial real estate and multi-family residential loans: | | | | |
| Construction and land development loans | 1,890 | 0 | 429 | 0 |
| Owner occupied loans | 2,876 | 0 | 4,371 | 0 |
| Nonowner occupied loans | 19,575 | 0 | 21,971 | 0 |
| Multifamily loans | 0 | 0 | 0 | 0 |
| Agri-business and agricultural loans: | | | | |
| Loans secured by farmland | 820 | 0 | 628 | 0 |
| Loans for agricultural production | 0 | 0 | 225 | 0 |
| Other commercial loans | 0 | 0 | 0 | 0 |
| Consumer 1-4 family mortgage loans: | | | | |
| Closed end first mortgage loans | 459 | 107 | 1,193 | 52 |
| Open end and junior lien loans | 424 | 2 | 452 | 0 |
| Residential construction loans | 0 | 0 | 0 | 0 |
| Other consumer loans | 54 | 0 | 7 | 0 |
| Total | $ 33,459 | $ 109 | $ 39,452 | $ 52 |

The recorded investment in loans does not include accrued interest.

The following table presents the aging of the recorded investment in past due loans as of September 30, 2012 by class of loans:

| | 30-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due | Loans Not Past Due | Total |
|---|---|---|---|---|---|
| Commercial and industrial loans: | | | | | |
| Working capital lines of credit loans | $ 332 | $ 2,012 | $ 2,344 | $ 443,804 | $ 446,148 |
| Non-working capital loans | 246 | 5,349 | 5,595 | 377,276 | 382,871 |
| Commercial real estate and multi-family residential loans: | | | | | |
| Construction and land development loans | 0 | 1,890 | 1,890 | 85,856 | 87,746 |
| Owner occupied loans | 860 | 2,876 | 3,736 | 359,747 | 363,483 |
| Nonowner occupied loans | 0 | 19,575 | 19,575 | 288,125 | 307,700 |
| Multifamily loans | 0 | 0 | 0 | 25,434 | 25,434 |
| Agri-business and agricultural loans: | | | | | |
| Loans secured by farmland | 0 | 820 | 820 | 118,717 | 119,537 |
| Loans for agricultural production | 0 | 0 | 0 | 94,633 | 94,633 |
| Other commercial loans | 0 | 0 | 0 | 44,974 | 44,974 |
| Consumer 1-4 family mortgage loans: | | | | | |
| Closed end first mortgage loans | 2,123 | 566 | 2,689 | 103,210 | 105,899 |
| Open end and junior lien loans | 197 | 426 | 623 | 168,424 | 169,047 |
| Residential construction loans | 44 | 0 | 44 | 11,231 | 11,275 |
| Other consumer loans | 235 | 54 | 289 | 44,352 | 44,641 |
| Total | $ 4,037 | $ 33,568 | $ 37,605 | $ 2,165,783 | $ 2,203,388 |

The recorded investment in loans does not include accrued interest.

The following table presents the aging of the recorded investment in past due loans as of December 31, 2011 by class of loans:

| | 30-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due (in thousands) | Loans Not Past Due | Total |
|---|---|---|---|---|---|
| Commercial and industrial loans: | | | | | |
| Working capital lines of credit loans | $ 1,051 | $ 4,743 | $ 5,794 | $368,098 | $373,892 |
| Non-working capital loans | 21 | 5,433 | 5,454 | 372,018 | 377,472 |
| Commercial real estate and multi-family residential loans: | | | | | |
| Construction and land development loans | 0 | 429 | 429 | 81,650 | 82,079 |
| Owner occupied loans | 104 | 4,371 | 4,475 | 342,068 | 346,543 |
| Nonowner occupied loans | 0 | 21,971 | 21,971 | 362,710 | 384,681 |
| Multifamily loans | 0 | 0 | 0 | 38,374 | 38,374 |
| Agri-business and agricultural loans: | | | | | |
| Loans secured by farmland | 0 | 628 | 628 | 117,619 | 118,247 |
| Loans for agricultural production | 0 | 225 | 225 | 119,531 | 119,756 |
| Other commercial loans | 0 | 0 | 0 | 58,249 | 58,249 |
| Consumer 1-4 family mortgage loans: | | | | | |
| Closed end first mortgage loans | 2,569 | 1,245 | 3,814 | 102,970 | 106,784 |
| Open end and junior lien loans | 254 | 452 | 706 | 175,517 | 176,223 |
| Residential construction loans | 34 | 0 | 34 | 5,415 | 5,449 |
| Other consumer loans | 192 | 7 | 199 | 45,761 | 45,960 |
| Total | $ 4,225 | $ 39,504 | $ 43,729 | $2,189,980 | $2,233,709 |

The recorded investment in loans does not include accrued interest.

**Troubled Debt Restructurings:**

Troubled debt restructured loans are included in the totals for impaired loans. The Company has allocated $14.7 million and $15.7 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2012 and December 31, 2011. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Accruing troubled debt restructured loans | $ 26,106 | $ 22,177 |
| Nonaccrual troubled debt restructured loans | 28,979 | 34,273 |
| Total troubled debt restructured loans | $ 55,085 | $ 56,450 |

During the three and nine months ending September 30, 2012 certain loans were modified as troubled debt restructurings. The modified terms of these loans include one or a combination of the following: inadequate compensation for the terms of the restructure or renewal; a reduction in the interest rate on a loan to one that would not be readily available in the marketplace for borrowers with a similar risk profile; a modification of the repayment terms which delays principal repayment for some period; or renewal terms offered to borrowers in financial distress where no additional credit enhancements were obtained at the time of renewal.

There were renewal terms on several loans offered to borrowers under financial distress which did not require additional compensation or consideration and would not have been readily available in the marketplace for loans bearing similar risk profiles. In this instance, it was determined that a concession had been granted. It is difficult to quantify the concession granted due to an absence in market terms to be used for comparison. The renewals during the first three months were to one borrower engaged in construction and land development, where the aggregate recorded investment totaled $1.6 million. The renewal during the three months ended June 30, 2012, was a non-working capital term loan with a recorded investment of $1.1 million. During the three months ended September 30, 2012, the Bank renegotiated terms on a loan where the collateral securing the original note was sold for an amount that did not satisfy the balance. The Bank agreed to release its collateral interest to facilitate the sale, and renegotiated another consumer loan with a recorded investment of $17,000 for the remaining balance of the loan. The terms offered in the renegotiated unsecured loan were an exception to bank policy, therefore it was determined that a concession had been granted. These loans are included in the table of all modifications below.

Renegotiated interest rates include loans with a reduction in rate for a short-term (part of the remaining life of the loan) or long-term (life of loan). There were modifications to borrowers at rates that were readily available in the market, but to borrowers who would not have qualified for the terms offered in the modification without a concession being granted. Also included are borrowers who received interest rate concessions that were below market rates.

Delays in principal repayment include loans which were intended to be amortizing during the period, but due to financial hardship the borrowers under these loans were unable to meet the original or intended repayment terms. These include loans with principal deferrals for a prolonged period or those with modified payments which are an exception to bank policy.

The following table presents loans by class modified as troubled debt restructurings that occurred during the nine month and three month periods ending September 30, 2012:

| | Modifications<br>Nine Months Ended September 30, 2012<br>All Modifications | | |
|---|---|---|---|
| Troubled Debt Restructurings | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Commercial and industrial loans: | | | |
| Non-working capital loans | 1 | $ 942 | $ 1,060 |
| Commercial real estate and multi-family residential loans: | | | |
| Construction and land development loans | 5 | 1,638 | 1,638 |
| Owner occupied loans | 2 | 2,260 | 2,260 |
| Nonowner occupied loans | 1 | 385 | 385 |
| Consumer 1-4 family loans: | | | |
| Closed end first mortgage loans | 1 | 39 | 39 |
| Other consumer loans | 1 | 17 | 17 |
| Total | 11 | $ 5,281 | $ 5,399 |

20

| Troubled Debt Restructurings | Interest Rate Reductions | | | Modified Repayment Terms | |
|---|---|---|---|---|---|
| | Number of Loans | Interest at Pre-Modification Rate | Interest at Post-Modification Rate | Number of Loans | Extension Period or Range (in months) |
| Commercial and industrial loans: | | | | | |
| Non-working capital loans | 0 | $ 0 | $ 0 | 0 | 0 |
| Commercial real estate and multi-family residential loans: | | | | | |
| Owner occupied loans | 1 | 440 | 117 | 1 | 18 |
| Nonowner occupied loans | 0 | 0 | 0 | 1 | 14 |
| Consumer 1-4 family loans: | | | | | |
| Closed end first mortgage loans | 1 | 76 | 15 | 0 | 0 |
| Other consumer loans | 0 | 0 | 0 | 0 | 0 |
| Total | 2 | $ 516 | $ 132 | 2 | 14-18 |

| Troubled Debt Restructurings | Modifications Three Months Ended September 30, 2012 All Modifications | | |
|---|---|---|---|
| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Commercial real estate and multi-family residential loans: | | | |
| Owner occupied loans | 1 | $ 1,411 | $ 1,411 |
| Other consumer loans | 1 | 17 | 17 |
| Total | 2 | $ 1,428 | $ 1,428 |

| Troubled Debt Restructurings | Modified Repayment Terms Number of Loans | Extension Period or Range (in months) |
|---|---|---|
| Commercial real estate and multi-family residential loans: | | |
| Owner occupied loans | 1 | 18 |
| Other consumer loans | 0 | 0 |
| Total | 1 | 18 |

For the three month period ending September 30, 2012 the commercial and industrial loan troubled debt restructurings described above decreased the allowance for loan losses by $15,000, the commercial real estate and multi-family residential loan troubled debt restructuring described above increased the allowance for loan losses by $11,000, the consumer 1-4 family loan troubled debt restructurings described above decreased the allowance for loan losses by $1,000 and the other consumer loan troubled debt restructuring described above increased the allowance for loan losses by $4,000.

For the nine month period ending September 30, 2012 the commercial and industrial loan troubled debt restructurings described above decreased the allowance for loan losses by $534,000, the commercial real estate and multi-family residential loan troubled debt restructurings described above decreased the allowance for loan losses by $18,000, the consumer 1-4 family loan troubled debt restructurings described above increased the allowance for loan losses by $5,000 and other consumer loan trouble debt restructuring described above increased the allowance for loan losses by $4,000.

No charge offs resulted from any troubled debt restructurings described above during the three and nine month periods ending September 30, 2012.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification which occurred during the three month and nine month periods ending September 30, 2012:

| | Modifications Three months ended September 30, 2012 | | Nine months ended September 30, 2012 | |
|---|---|---|---|---|
| | Number of Loans | Recorded Investment | Number of Loans | Recorded Investment |
| Troubled Debt Restructurings that Subsequently Defaulted | | | | |
| Consumer 1-4 family loans: | | | | |
| Closed end first mortgage loans | 0 | $ 0 | 1 | $ 65 |
| Total | 0 | $ 0 | 1 | $ 65 |

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

The troubled debt restructurings that subsequently defaulted described above increased the allowance for loan losses by $17,000 and did not result in any charge offs during the three and nine month periods ending September 30, 2012.

During the year ending December 31, 2011, the terms of certain loans were modified as troubled debt restructurings. The modified terms of these loans included one or a combination of the following: a reduction of the stated interest rate of the loan below market rates; principal and interest forgiveness; a modification of repayment terms that delays principal repayment for some period; or inadequate compensation for the terms of the restructure. Clarifications in the accounting guidance for troubled debt restructurings that became effective in the third quarter of 2011 resulted in $15.6 million being added to total troubled debt restructured loans in 2011. Of the $15.6 million added, $15.3 million was included in nonperforming and impaired loans at December 31, 2010.

Loans with renegotiated interest rates include reductions in rate for a short-term (part of the remaining life of the loan) or long-term (life of loan). Included are modifications to borrowers at a rate that is readily available in the market, but for borrowers who would not have otherwise qualified for the terms offered in the modification without a concession being granted. Also included are borrowers who received interest rate concessions that are below market rates.

23

Delays in principal repayment include loans that were intended to be amortizing during the period, but, due to financial hardship, these borrowers were unable to meet the original or intended repayment terms. These include loans with principal deferrals for a prolonged period or those with modified payments, which are an exception to bank policy.

Inadequate compensation for the terms of the restructure were identified in some loans where terms offered would not have been readily available in the marketplace for loans bearing similar risk profiles, including loans that were renewed under terms similar to original terms. In some instances it was determined that a concession had been granted; however, it is difficult to quantify these concessions due to an absence in market terms to be used for comparison. These loans included two non-working capital loans with a recorded investment of $636,000, one non-owner occupied loan with a recorded investment of $642,000 and one loan secured by farmland with a recorded investment of $413,000. These loans are included in the table of all modifications below.

The following tables present loans by class modified as troubled debt restructurings that occurred during the period ending December 31, 2011:

| | All Modifications Classified as Troubled Debt Restructurings | | |
|---|---|---|---|
| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Troubled Debt Restructurings | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | 3 | $ 639 | $ 639 |
| Non-working capital loans | 6 | 6,187 | 6,261 |
| Commercial real estate and multi-family residential loans: | | | |
| Construction and land development loans | | | |
| Owner occupied loans | 8 | 6,648 | 6,651 |
| Nonowner occupied loans | 8 | 23,767 | 23,767 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 2 | 683 | 683 |
| Consumer 1-4 family loans: | | | |
| Closed end first mortgage loans | 6 | 942 | 849 |
| Total | 33 | $ 38,866 | $ 38,850 |

| | Interest Rate Reductions | | | Principal and Interest Forgiveness | | | | | Modified Repayment Terms | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Number of Loans | Interest at Pre-Modification Rate | Interest at Post-Modification Rate | Number of Loans | Principal at Pre-Modification Rate | Principal at Post-Modification Rate | Interest at Pre-Modification Rate | Interest at Post-Modification Rate | Number of Loans | Extension Period or Range (in months) |
| | | | | | (in thousands) | | | | | |
| Troubled Debt Restructurings | | | | | | | | | | |
| Commercial and industrial loans: | | | | | | | | | | |
| Working capital lines of credit loans | 0 | $ 0 | $ 0 | 0 | $0 | $ 0 | $ 0 | $ 0 | 3 | 11-60 |
| Non-working capital loans | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4 | 12-36 |
| Commercial real estate and multi-family residential loans: | | | | | | | | | | |
| Owner occupied loans | 0 | 0 | 0 | 1 | 2,125 | 2,125 | 641 | 429 | 7 | 20-70 |
| Nonowner occupied loans | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 7 | 6-36 |
| Agri-business and agricultural loans: | | | | | | | | | | |
| Loans secured by farmland | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 22 |
| Consumer 1-4 family loans: | | | | | | | | | | |
| Closed end first mortgage loans | 5 | 402 | 324 | 1 | 550 | 450 | 66 | 57 | 0 | 0 |
| Total | 5 | $ 402 | $ 324 | 2 | $2,675 | $ 2,575 | $ 707 | $ 486 | 22 | 6-70 |

All of the commercial and industrial loan troubled debt restructurings described above also had inadequate compensation of additional collateral as part of the restructuring.

For the period ending December 31, 2011, the commercial and industrial loan troubled debt restructurings described above decreased the allowance for loan losses by $112,000, the commercial real estate and multi-family residential loan troubled debt restructurings described above increased the allowance for loan losses by $3.2 million, the agri-business and agricultural loan troubled debt restructurings described above decreased the allowance for loan losses by $11,000 and the consumer 1-4 family loan troubled debt restructurings described above increased the allowance for loan losses by $76,000. The five commercial and industrial loans and one agri-business and agricultural loan that decreased the provision during 2011 had modifications during the first five months of the year and had improved their positions during the remainder of the year warranting the decrease in allocation.

The commercial real estate and multi-family residential loan troubled debt restructurings described above also resulted in charge offs of $667,000 during the period ending December 31, 2011. No charge offs resulted from any other troubled debt restructurings described above during the period ending December 31, 2011.

**Credit Quality Indicators:**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes commercial loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for Special Mention, Substandard and Doubtful grade loans and annually on Pass grade loans over $250,000.

The Company uses the following definitions for risk ratings:

**Special Mention.** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be Pass rated loans with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans. Loans listed as Not Rated are consumer loans included in groups of homogenous loans which are analyzed for credit quality indicators utilizing delinquency status. As of September 30, 2012 and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| | Pass | Special Mention | Substandard | Doubtful | Not Rated |
|---|---|---|---|---|---|
| | | (in thousands) | | | |
| Commercial and industrial loans: | | | | | |
| Working capital lines of credit loans | $420,757 | $12,274 | $ 13,117 | $ 0 | $0 |
| Non-working capital loans | 342,447 | 7,664 | 31,484 | 0 | 1,276 |
| Commercial real estate and multi-family residential loans: | | | | | |
| Construction and land development loans | 71,130 | 5,520 | 11,096 | 0 | 0 |
| Owner occupied loans | 334,835 | 7,161 | 21,437 | 0 | 50 |
| Nonowner occupied loans | 271,419 | 9,827 | 26,454 | 0 | 0 |
| Multifamily loans | 24,235 | 1,199 | 0 | 0 | 0 |
| Agri-business and agricultural loans: | | | | | |
| Loans secured by farmland | 118,012 | 70 | 1,436 | 0 | 19 |
| Loans for agricultural production | 94,633 | 0 | 0 | 0 | 0 |
| Other commercial loans | 44,856 | 0 | 118 | 0 | 0 |
| Consumer 1-4 family mortgage loans: | | | | | |
| Closed end first mortgage loans | 21,380 | 329 | 423 | 0 | 83,767 |
| Open end and junior lien loans | 11,494 | 300 | 0 | 0 | 157,253 |
| Residential construction loans | 0 | 0 | 0 | 0 | 11,275 |
| Other consumer loans | 8,282 | 356 | 497 | 0 | 35,506 |
| Total | $1,763,480 | $44,700 | $ 106,062 | $ 0 | $289,146 |

The recorded investment in loans does not include accrued interest.

28

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be Pass rated loans with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans. Loans listed as Not Rated are consumer loans included in groups of homogenous loans which are analyzed for credit quality indicators utilizing delinquency status. As of December 31, 2011 and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| | Pass | Special Mention | Substandard | Doubtful | Not Rated |
|---|---|---|---|---|---|
| | | (in thousands) | | | |
| Commercial and industrial loans: | | | | | |
| Working capital lines of credit loans | $352,055 | $5,625 | $ 16,212 | $ 0 | $0 |
| Non-working capital loans | 331,881 | 7,437 | 36,751 | 0 | 1,403 |
| Commercial real estate and multi-family residential loans: | | | | | |
| Construction and land development loans | 64,808 | 3,296 | 13,976 | 0 | 0 |
| Owner occupied loans | 318,191 | 5,913 | 22,400 | 0 | 38 |
| Nonowner occupied loans | 337,090 | 8,875 | 38,716 | 0 | 0 |
| Multifamily loans | 37,127 | 1,247 | 0 | 0 | 0 |
| Agri-business and agricultural loans: | | | | | |
| Loans secured by farmland | 116,742 | 70 | 1,415 | 0 | 20 |
| Loans for agricultural production | 119,531 | 0 | 225 | 0 | 0 |
| Other commercial loans | 58,061 | 66 | 120 | 0 | 2 |
| Consumer 1-4 family mortgage loans: | | | | | |
| Closed end first mortgage loans | 17,307 | 53 | 974 | 0 | 88,450 |
| Open end and junior lien loans | 11,569 | 319 | 0 | 0 | 164,335 |
| Residential construction loans | 0 | 0 | 0 | 0 | 5,449 |
| Other consumer loans | 7,416 | 375 | 497 | 0 | 37,672 |
| Total | $1,771,778 | $33,276 | $ 131,286 | $ 0 | $297,369 |

The recorded investment in loans does not include accrued interest.

**NOTE 5. SECURITIES**

Information related to the fair value and amortized cost of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) is provided in the tables below.

| | Fair Value | Gross Unrealized Gain | Gross Unrealized Losses | Amortized Cost |
|---|---|---|---|---|
| September 30, 2012 | | | | |
| U.S. Treasury securities | $1,042 | $ 40 | $ 0 | $ 1,002 |
| U.S. government sponsored agencies | 5,316 | 288 | 0 | 5,028 |
| Agency residential mortgage-backed securities | 385,298 | 9,051 | (1,511 ) | 377,758 |
| Non-agency residential mortgage-backed securities | 6,982 | 267 | 0 | 6,715 |
| State and municipal securities | 82,618 | 5,740 | (43 ) | 76,921 |
| Total | $481,256 | $ 15,386 | $ (1,554 ) | $ 467,424 |
| | | | | |
| December 31, 2011 | | | | |
| U.S. Treasury securities | $1,055 | $ 52 | $ 0 | $ 1,003 |
| U.S. government sponsored agencies | 5,277 | 244 | 0 | 5,033 |
| Agency residential mortgage-backed securities | 350,102 | 8,989 | (923 ) | 342,036 |
| Non-agency residential mortgage-backed securities | 32,207 | 191 | (2,225 ) | 34,241 |
| State and municipal securities | 78,750 | 5,292 | (9 ) | 73,467 |
| Total | $467,391 | $ 14,768 | $ (3,157 ) | $ 455,780 |

Total other-than-temporary impairment recognized in accumulated other comprehensive income was $0 at September 30, 2012 and $213,000 at December 31, 2011.

Information regarding the fair value and amortized cost of available for sale debt securities by maturity as of September 30, 2012 is presented below. Maturity information is based on contractual maturity for all securities other than mortgage-backed securities. Actual maturities of securities may differ from contractual maturities because borrowers may have the right to prepay the obligation without prepayment penalty.

| | Amortized Cost | Fair Value |
|---|---|---|
| Due in one year or less | $ 2,118 | $2,106 |
| Due after one year through five years | 23,461 | 25,108 |
| Due after five years through ten years | 35,516 | 38,272 |
| Due after ten years | 21,856 | 23,490 |
| | 82,951 | 88,976 |

| | | |
|---|---|---|
| Mortgage-backed securities | 384,473 | 392,280 |
| Total debt securities | $ 467,424 | $ 481,256 |

Security proceeds, gross gains and gross losses are presented below.

| | Nine months ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Sales of securities available for sale | | |
| Proceeds | $ 28,877 | $ 73,318 |
| Gross gains | 823 | 4,005 |
| Gross losses | (1,203 ) | (4,171 ) |

| | Three months ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Sales of securities available for sale | | |
| Proceeds | $ 28,877 | $ 0 |
| Gross gains | 823 | 0 |
| Gross losses | (1,203 ) | 0 |

The Company sold eleven securities with a total book value of $29.3 million and a total fair value of $28.9 million during the first nine months of 2012. The sales included nine non-agency residential mortgage backed securities, including all five on which the Company had previously recognized other-than-temporary impairment. The remaining gains during the first nine months of 2012 were from calls. The Company sold 36 securities with a total book value of $73.5 million and a total fair value of $73.3 million during the first nine months of 2011. The sales in 2011 included eight non-agency residential mortgage backed securities. The securities sales in both 2012 and 2011 were related to a strategic realignment of the securities portfolio.

Purchase premiums or discounts are recognized in interest income using the interest method over the terms of the securities or over estimated lives for mortgage-backed securities. Gains and losses on sales are based on the amortized cost of the security sold and recorded on the trade date.

Securities with carrying values of $199.3 million and $249.8 million were pledged as of September 30, 2012 and 2011, as collateral for deposits of public funds, securities sold under agreements to repurchase, borrowings from the Federal Home Loan Bank and for other purposes as permitted or required by law.

Information regarding securities with unrealized losses as of September 30, 2012 and December 31, 2011 is presented below. The tables distribute the securities between those with unrealized losses for less than twelve months and those with unrealized losses for twelve months or more.

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2012 | | | | | | |
| Agency residential mortgage-backed securities | $85,988 | $ (998 ) | $31,206 | $ (513 ) | $117,194 | $ (1,511 ) |
| State and municipal securities | 4,250 | (42 ) | 50 | (1 ) | 4,300 | (43 ) |
| Total temporarily impaired | $90,238 | $ (1,040 ) | $31,256 | $ (514 ) | $121,494 | $ (1,554 ) |

31

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2011 | | | | | | |
| Agency residential mortgage-backed securities | $74,463 | $ (860 ) | $4,813 | $ (63 ) | $79,276 | $ (923 ) |
| Non-agency residential mortgage-backed securities | 3,379 | (4 ) | 23,885 | (2,221 ) | 27,264 | (2,225 ) |
| State and municipal securities | 341 | (2 ) | 1,003 | (7 ) | 1,344 | (9 ) |
| Total temporarily impaired | $78,183 | $ (866 ) | $29,701 | $ (2,291 ) | $107,884 | $ (3,157 ) |

The number of securities with unrealized losses as of September 30, 2012 and December 31, 2011 is presented below.

| September 30, 2012 | Less than 12 months | 12 months or more | Total |
|---|---|---|---|
| Agency residential mortgage-backed securities | 21 | 11 | 32 |
| State and municipal securities | 22 | 1 | 23 |
| Total temporarily impaired | 43 | 12 | 55 |

| December 31, 2011 | Less than 12 months | 12 months or more | Total |
|---|---|---|---|
| Agency residential mortgage-backed securities | 21 | 1 | 22 |
| Non-agency residential mortgage-backed securities | 2 | 9 | 11 |
| State and municipal securities | 3 | 2 | 5 |
| Total temporarily impaired | 26 | 12 | 38 |

All of the following are considered to determine whether or not the impairment of these securities is other-than-temporary. Ninety-eight percent of the securities are backed by the U.S. government, government agencies, government sponsored agencies or are A rated or better, except for certain non-local municipal securities which are not rated. Mortgage-backed securities which are not issued by the U.S. government or government sponsored agencies (non-agency residential mortgage-backed securities) met specific criteria set by the Asset Liability Management Committee at their time of purchase, including having the highest rating available by either Moody’s or S&P. None of the securities have call provisions (with the exception of the municipal securities) and all payments on the securities have been received on their original terms. For the government, government-sponsored agency and municipal securities, management was not concerned about the risk of credit losses, and there was nothing to indicate that full payment of the principal will not be received. Management considered the unrealized losses on these securities to be primarily interest rate driven and does not expect material losses given current market conditions unless the securities are sold. However, at this time management does not have the intent to sell and it is more likely than not that it will not be required to sell these securities before the recovery of their amortized cost basis.

As of September 30, 2012, the Company had $7.0 million of non-agency residential mortgage-backed securities which were not issued by the federal government or government sponsored agencies, but were rated AAA by S&P and/or Aaa by Moody's at the time of purchase. At December 31, 2011, the Company had $32.2 million of these non-agency residential mortgage-backed securities. During the third quarter of 2012 the Company sold nine of the non-agency residential mortgage backed securities as part of a strategic realignment of the investment portfolio. The securities sold had a book value of $20.7 million and a fair value of $19.5 million. The sales included all five of the securities on which the Company had previously recognized other-than-temporary impairment. None of the five remaining non-agency residential mortgage backed securities were still rated AAA/Aaa as of September 30, 2012 by at least one of the rating agencies S&P, Moody's and Fitch, however, none of the five have been downgraded to below investment grade by any of those rating agencies.

For these non-agency residential mortgage-backed securities, additional analysis is performed to determine if the impairment is temporary or other-than-temporary in which case impairment would need to be recorded for these securities. The Company performs an independent analysis of the cash flows of the individual securities based upon assumptions as to collateral defaults, prepayment speeds, expected losses and the severity of potential losses. Based upon the initial review, securities may be identified for further analysis by computing the net present value using an appropriate discount rate (the current accounting yield) and comparing it to the book value of the security to determine if there is any other-than-temporary impairment that must be recorded. Based on this analysis of the non-agency residential mortgage-backed securities, the Company recorded an other-than-temporary impairment of $67,000 and $1.0 million, respectively, relating to four securities in the three-months and nine-months ended September 30, 2012, which is equal to the credit loss, establishing a new, lower amortized cost basis. All of the securities on which the Company had recognized other-than-temporary impairment were sold during the third quarter of 2012. None of the five remaining non-agency mortgage backed securities had any unrealized losses at September 30, 2012.

The following table provides information about debt securities for which only a credit loss was recognized in income and other losses are recorded in other comprehensive income. The table represents the three months and nine months ended September 30, 2012 and 2011.

| | Three Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Balance July 1, | $1,318 | $194 |
| Additions related to other-than-temporary impairment losses not previously recognized | 0 | 0 |
| Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized | 67 | 33 |
| Reductions for previous credit losses realized on securities sold during the year | (1,385) | 0 |
| Balance September 30, | $0 | $227 |

| | Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|
| Balance January 1, | $359 | $1,812 |
| Additions related to other-than-temporary impairment losses not previously recognized | 747 | 0 |
| Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized | 279 | 154 |
| Reductions for previous credit losses realized on securities sold during the year | (1,385) | (1,739) |
| Balance September 30, | $0 | $227 |

The Company does not have a history of actively trading securities, but keeps the securities available for sale should liquidity or other needs develop that would warrant the sale of securities. While these securities are held in the available for sale portfolio, it is management's current intent and ability to hold them until a recovery in fair value or maturity.

**NOTE 6. EMPLOYEE BENEFIT PLANS**

Components of net periodic benefit cost:

| | Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | Pension Benefits | | SERP Benefits | |
| | 2012 | 2011 | 2012 | 2011 |
| Interest cost | $95 | $105 | $38 | $46 |
| Expected return on plan assets | (102) | (119) | (56) | (60) |
| Recognized net actuarial loss | 102 | 80 | 62 | 52 |
| Net pension expense | $95 | $66 | $44 | $38 |

| | Three Months Ended September 30, | | | |
|---|---|---|---|---|
| | Pension Benefits | | SERP Benefits | |
| | 2012 | 2011 | 2012 | 2011 |
| Interest cost | $31 | $33 | $12 | $12 |
| Expected return on plan assets | (34) | (41) | (18) | (20) |
| Recognized net actuarial loss | 35 | 40 | 20 | 22 |
| Net pension expense | $32 | $32 | $14 | $14 |

The Company previously disclosed in its financial statements for the year ended December 31, 2011 that it expected to contribute $170,000 to its pension plan and $114,000 to its SERP plan in 2012. The Company has contributed $121,000 to its pension plan and $114,000 to its SERP plan as of September 30, 2012. The Company expects to contribute an additional $49,000 to its pension plan during the remainder of 2012. The Company does not expect to make any additional contributions to its SERP plan during the remainder of 2012.

**NOTE 7. NEW ACCOUNTING PRONOUNCEMENTS**

In May 2011, the FASB issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and international accounting principles. The amendment results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards (“IFRS”). The changes to U.S. GAAP as a result of the amendment are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. The amendment extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity’s net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) The exception aligns the fair value measurement of instruments classified within an entity’s stockholders’ equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for recurring Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The provisions of the amendment are effective for the Company’s interim and annual periods beginning on or after December 15, 2011. The adoption of this standard did not have a material impact on the Company’s statements of income and condition and the disclosure requirements are already included.

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in stockholders’ equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. In December 2011, the FASB deferred the effective date for amendments to the presentation of reclassifications of items out of accumulated other comprehensive income. The adoption of the remaining amendments changed the presentation of the components of comprehensive income for the Company as part of Note 9 into two consecutive statements. These amendments are effective for interim and annual periods beginning on or after December 15, 2011. The adoption of this standard did not have a material impact on the Company’s statements of income and condition.

In September 2011, the FASB amended existing guidance relating to goodwill impairment testing. The amendment permits an assessment of qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing these events or circumstances, it is concluded that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. The amendments in this guidance are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this standard did not have a material impact on the Company’s statements of income and condition.

35

**NOTE 8. FAIR VALUE DISCLOSURES**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

| | |
|---|---|
| Level 1 | Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date. |
| Level 2 | Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data. |
| Level 3 | Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability. |

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

Securities: Securities available for sale are valued primarily by a third party pricing service. The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or pricing models utilizing significant observable inputs such as matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). These models utilize the market approach with standard inputs that include, but are not limited to benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. For certain municipal securities that are not rated and observable inputs about the specific issuer are not available, fair values are estimated using observable data from other municipal securities presumed to be similar or other market data on other non-rated municipal securities (Level 3 inputs). There were no transfers from or into Level 1, Level 2 or Level 3 during the first nine months of 2012.

Mortgage banking derivatives: The fair value of derivatives are based on observable market data as of the measurement date (Level 2).

Impaired loans: Impaired loans with specific allocations of the allowance for loan losses are generally based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Fair value is determined using several methods. Generally, the fair value of real estate is based on appraisals by qualified third party appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and result in a Level 3 classification of the inputs for determining fair value. In addition, the Company’s management routinely applies internal discount factors to the value of appraisals used in the fair value evaluation of impaired loans. The deductions to the appraisals take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. Commercial real estate is generally discounted from its appraised value by 0-50% with the higher discounts applied to real estate that is determined to have a thin trading market or to be specialized collateral. In addition to real estate, the Company’s management evaluates other types of collateral as follows: Raw and finished inventory is discounted from its cost or book value by 35-65%, depending on the marketability of the goods. Finished goods are generally discounted by 30-60%, depending on the ease of marketability, cost of transportation or scope of use of the finished good. Work in process inventory is typically discounted by 50-100%, depending on the length of manufacturing time, types of components used in the completion process, and the breadth of the user base. Equipment is valued at a percentage of depreciated book value or recent appraised value, if available, and is typically discounted at 30-70% after various considerations including age and condition of the equipment, marketability, breadth of use, and whether the equipment includes unique components or add-ons. Marketable securities are discounted by 10-30%, depending on the type of investment, age of valuation report and general market conditions. This methodology is based on a market approach and typically results in a Level 3 classification of the inputs for determining fair value.

Mortgage servicing rights: As of September 30, 2012 the fair value of the Company’s Level 3 servicing assets for residential mortgage loans was $2.0 million, some of which are not currently impaired and therefore carried at amortized cost. These residential mortgage loans have a weighted average interest rate of 4.58%, a weighted average maturity of 19 years and are secured by homes generally within the Company’s market area, which is primarily Northern Indiana. A valuation model is used to estimate fair value, which is based on an income approach. The inputs used include estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income. The most significant assumption used to value mortgage servicing rights is prepayment rate. Prepayment rates are estimated based on published industry consensus prepayment rates. The most significant unobservable assumption is the discount rate. At September 30, 2012 the constant prepayment speed (PSA) used was 447 and the discount rate used was 9.2%. At December 31, 2011 the constant prepayment speed (PSA) used was 387 and the discount rate used was 9.2%.

Other real estate owned: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property and are reviewed by the Company’s internal appraisal officer. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales. Such adjustments are usually significant and result in a Level 3 classification. In addition, the Company’s management may apply discount factors to the appraisals to take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Real estate mortgage loans held for sale: Real estate mortgage loans held for sale are carried at the lower of cost or fair value, as determined by outstanding commitments, from third party investors, and results in a Level 2 classification.

The table below presents the balances of assets measured at fair value on a recurring basis:

| Assets | September 30, 2012 Fair Value Measurements Using Level 1 | Level 2 | Level 3 | Assets at Fair Value |
|---|---|---|---|---|
| U.S. Treasury securities | $1,042 | $0 | $ 0 | $ 1,042 |
| U.S. Government sponsored agencies | 0 | 5,316 | 0 | 5,316 |
| Residential mortgage-backed securities | 0 | 385,298 | 0 | 385,298 |
| Non-agency residential mortgage-backed securities | 0 | 6,982 | 0 | 6,982 |
| State and municipal securities | 0 | 81,981 | 637 | 82,618 |
| Total Securities | 1,042 | 479,577 | 637 | 481,256 |
| Mortgage banking derivative | 0 | 917 | 0 | 917 |
| Total assets | $1,042 | $480,494 | $ 637 | $ 482,173 |
| Liabilities | | | | |
| Mortgage banking derivative | $0 | $(319 ) | $ 0 | $ (319 ) |

| Assets | December 31, 2011 Fair Value Measurements Using Level 1 | Level 2 | Level 3 | Assets at Fair Value |
|---|---|---|---|---|
| U.S. Treasury securities | $1,055 | $0 | $ 0 | $ 1,055 |
| U.S. Government sponsored agencies | 0 | 5,277 | 0 | 5,277 |
| Residential mortgage-backed securities | 0 | 350,102 | 0 | 350,102 |
| Non-agency residential mortgage-backed securities | 0 | 32,207 | 0 | 32,207 |
| State and municipal securities | 0 | 78,064 | 686 | 78,750 |
| Total Securities | 1,055 | 465,650 | 686 | 467,391 |
| Mortgage banking derivative | 0 | 406 | 0 | 406 |
| Total assets | $1,055 | $466,056 | $ 686 | $ 467,797 |
| Liabilities | | | | |
| Mortgage banking derivative | $0 | $(81 ) | $ 0 | $ (81 ) |

There were no transfers from or into Level 1, Level 2 or Level 3 during 2012 and there were no transfers from or into Level 1 or Level 2 during the nine months ended September 30, 2011.

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2012:

| | State and Municipal Securities September 30, 2012 | |
|---|---|---|
| Balance or recurring Level 3 assets at January 1 | $ | 686 |
| Change in fair value of securities | | (4) |
| Principal payments | | (45) |
| Balance or recurring Level 3 assets at September 30 | $ | 637 |

The fair value of 3 state and municipal securities with a fair value of $686,000 as of December 31, 2011 were transferred out of Level 2 and into Level 3 because of a lack of observable market data for these investments. The Company’s policy is to recognize transfers as of the end of the reporting period. As a result, the fair value for these state and municipal securities was transferred on December 31, 2011.

The securities measured at fair value included below are nonrated Indiana municipal revenue bonds and are not actively traded.

Quantitative Information about Level 3 Fair Value Measurements

| | Fair Value at 9/30/2012 (in thousands) | Valuation Technique | Unobservable Input | Range (Weighted Average) |
|---|---|---|---|---|
| State and municipal securities | $ 637 | Price to type, par, call | Discount to benchmark index | 1 % |

The Company’s Controlling Department, which is responsible for all accounting and SEC compliance and the Company’s Treasury Department, which is responsible for investment portfolio management and asset/liability modeling, are the two areas that decide the Company’s valuation policies and procedures. Both of these areas report directly to the President and Chief Financial Officer of the Company. For assets or liabilities that may be considered for Level 3 fair value measurement on a recurring basis, these two areas and the President and Chief Financial Officer determine the appropriate level of the assets or liabilities under consideration. If there are assets or liabilities that are determined as Level 3 by this group, the Risk Management Committee of the Company and the Audit Committee of the Board of Directors are made aware of such assets at their next scheduled meeting.

Securities pricing is obtained from a third party pricing service and is tested at least annually against prices from another third party provider and reviewed with a market value tolerance variance of 3%. If any securities fall above this tolerance threshold, they are reviewed in more detail to determine why the variance exists. Changes in market value are reviewed monthly in aggregate yield by security type and any material differences are reviewed to determine why they exist. At least annually, the pricing methodology of the pricing service is received and reviewed to support the fair value levels used by the Company. A detailed pricing evaluation is requested and reviewed on any security determined to be fair value using unobservable inputs by the pricing service.

The primary methodology used in the fair value measurement of the Company's state and municipal securities classified as Level 3 is a discount to the AAA municipal benchmark index. Significant increases or (decreases) in this index as well as the degree to which the security differs in ratings, coupon, call and duration will result in a higher or (lower) fair value measurement for those securities that are not callable. For those securities that are continuously callable, a slight premium to par is used.

The table below presents the balances of assets measured at fair value on a nonrecurring basis:

| Assets | September 30, 2012 Fair Value Measurements Using Level 1 | Level 2 (in thousands) | Level 3 | Assets at Fair Value |
|---|---|---|---|---|
| Impaired loans: | | | | |
| Commercial and industrial loans: | | | | |
| Working capital lines of credit loans | $0 | $0 | $1,657 | $ 1,657 |
| Non-working capital loans | 0 | 0 | 5,275 | 5,275 |
| Commercial real estate and multi-family residential loans: | | | | |
| Construction and land development loans | 0 | 0 | 2,724 | 2,724 |
| Owner occupied loans | 0 | 0 | 4,760 | 4,760 |
| Nonowner occupied loans | 0 | 0 | 20,585 | 20,585 |
| Multifamily loans | 0 | 0 | 0 | 0 |
| Agri-business and agricultural loans: | | | | |
| Loans secured by farmland | 0 | 0 | 266 | 266 |
| Loans for agricultural production | 0 | 0 | 0 | 0 |
| Other commercial loans | 0 | 0 | 0 | 0 |
| Consumer 1-4 family mortgage loans: | | | | |
| Closed end first mortgage loans | 0 | 0 | 241 | 241 |
| Open end and junior lien loans | 0 | 0 | 162 | 162 |
| Residential construction loans | 0 | 0 | 0 | 0 |
| Other consumer loans | 0 | 0 | 27 | 27 |
| Total impaired loans | $0 | $0 | $35,697 | $ 35,697 |
| Mortgage servicing rights | 0 | 0 | 1,969 | 1,969 |
| Other real estate owned | 0 | 0 | 81 | 81 |

| | | | | |
|---|---|---|---|---|
| Total assets | $0 | $0 | $37,747 | $ 37,747 |

40

The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at September 30, 2012:

| | Fair Value | Valuation Methodology | Unobservable Inputs | Range of Inputs (Average) |
|---|---|---|---|---|
| Impaired Loans: Commercial and industrial: | $ 6,932 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 83% (25)% |
| Impaired loans: Commercial real estate: | 28,069 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 88% (40)% |
| Impaired loans: Agri-business and agricultural: | 266 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 9% - 24% (16)% |
| Impaired loans: Consumer 1-4 family mortgage | 403 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 20% (8)% |
| Impaired loans: Other consumer | 27 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 40% |
| Mortgage servicing rights | 1,969 | Discounted cash flows | Discount rate | 9.1% - 9.5% (9.2)% |
| Other real estate owned | 81 | Appraisals | Discount to reflect current market conditions | 49% - 61% (50)% |

| Assets | December 31, 2011 Fair Value Measurements Using Level 1 | Level 2 | Level 3 | Assets at Fair Value |
|---|---|---|---|---|
| | | (in thousands) | | |
| Impaired loans: | | | | |
| Commercial and industrial loans: | | | | |
| Working capital lines of credit loans | $0 | $0 | $2,762 | $2,762 |
| Non-working capital loans | 0 | 0 | 11,885 | 11,885 |
| Commercial real estate and multi-family residential loans: | | | | |
| Construction and land development loans | 0 | 0 | 303 | 303 |
| Owner occupied loans | 0 | 0 | 3,515 | 3,515 |
| Nonowner occupied loans | 0 | 0 | 23,591 | 23,591 |
| Multifamily loans | 0 | 0 | 0 | 0 |
| Agri-business and agricultural loans: | | | | |
| Loans secured by farmland | 0 | 0 | 433 | 433 |
| Loans for agricultural production | 0 | 0 | 207 | 207 |
| Other commercial loans | 0 | 0 | 0 | 0 |
| Consumer 1-4 family mortgage loans: | | | | |
| Closed end first mortgage loans | 0 | 0 | 878 | 878 |
| Open end and junior lien loans | 0 | 0 | 406 | 406 |
| Residential construction loans | 0 | 0 | 0 | 0 |
| Other consumer loans | 0 | 0 | 0 | 0 |
| Total impaired loans | $0 | $0 | $43,980 | $43,980 |
| Mortgage servicing rights | 0 | 0 | 1,734 | 1,734 |
| Other real estate owned | 0 | 0 | 730 | 730 |
| Total assets | $0 | $0 | $46,444 | $46,444 |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a gross carrying amount of $50.2 million, with a valuation allowance of $14.5 million at September 30, 2012, resulting in a net recovery in the provision for loan losses of $200,000 and $3.8 million, respectively, for the three months and nine months ended September 30, 2012. At September 30, 2011, impaired loans had a carrying amount of $56.4 million, with a valuation allowance of $16.6 million, resulting in an additional provision for loans losses of $7.8 million and $5.3 million, respectively, for the three months and nine months ending September 30, 2011.

Mortgage servicing rights, which are carried at the lower of cost or fair value, included a portion carried at their fair value of $2.0 million, which is made up of the outstanding balance of $2.2 million, net of a valuation allowance of $192,000 at September 30, 2012, resulting in impairment of $84,000 for the nine months ended September 30, 2012. The Company realized impairment of mortgage servicing rights of $162,000 for the nine months ended September 30, 2011.

The Company also recognized a $72,000 reduction in the value of other real estate owned during the nine months ended September 30, 2012. During the nine months ended September 30, 2011, the Company recognized a $76,000 reduction in the value of other real estate owned.

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments. Items which are not financial instruments are not included.

| | September 30, 2012 | | | | |
|---|---|---|---|---|---|
| | Carrying | Estimated Fair Value | | | |
| | Value | Level 1 | Level 2 | Level 3 | Total |
| Financial Assets: | | | | | |
| Cash and cash equivalents | $181,402 | $181,402 | $0 | $0 | $181,402 |
| Securities available for sale | 481,256 | 1,042 | 479,577 | 637 | 481,256 |
| Real estate mortgages held for sale | 6,707 | 0 | 6,826 | 0 | 6,826 |
| Loans, net | 2,151,476 | 0 | 0 | 2,179,321 | 2,179,321 |
| Federal Home Loan Bank stock | 7,313 | N/A | N/A | N/A | N/A |
| Federal Reserve Bank stock | 3,420 | N/A | N/A | N/A | N/A |
| Accrued interest receivable | 9,729 | 4 | 1,774 | 7,951 | 9,729 |
| Financial Liabilities: | | | | | |
| Certificates of deposit | (948,410) | 0 | (964,427) | 0 | (964,427) |
| All other deposits | (1,527,687) | (1,527,687) | 0 | 0 | (1,527,687) |
| Securities sold under agreements to repurchase | (118,552) | 0 | (118,552) | 0 | (118,552) |
| Long-term borrowings | (15,038) | 0 | (15,690) | 0 | (15,690) |
| Subordinated debentures | (30,928) | 0 | 0 | (31,232) | (31,232) |
| Standby letters of credit | (360) | 0 | 0 | (360) | (360) |
| Accrued interest payable | (5,718) | (289) | (5,426) | (3) | (5,718) |

43

| | December 31, 2011 | |
|---|---|---|
| | Carrying Value | Estimated Fair Value |
| Financial Assets: | | |
| Cash and cash equivalents | $104,584 | $104,584 |
| Securities available for sale | 467,391 | 467,391 |
| Real estate mortgages held for sale | 2,953 | 2,998 |
| Loans, net | 2,180,309 | 2,141,459 |
| Federal Home Loan Bank stock | 7,313 | N/A |
| Federal Reserve Bank stock | 3,420 | N/A |
| Accrued interest receivable | 9,604 | 9,604 |
| Financial Liabilities: | | |
| Certificates of deposit | (910,381) | (925,619) |
| All other deposits | (1,502,315) | (1,502,315) |
| Securities sold under agreements to repurchase | (131,990) | (131,990) |
| Other short-term borrowings | (10,000) | (10,000) |
| Long-term borrowings | (15,040) | (16,079) |
| Subordinated debentures | (30,928) | (31,240) |
| Standby letters of credit | (247) | (247) |
| Accrued interest payable | (5,574) | (5,574) |

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

Cash and cash equivalents - The carrying amount of cash and cash equivalents approximate fair value and are classified as Level 1.

Loans, net – Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using current market rates applied to the estimated life resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Federal Home Loan Bank stock and Federal Reserve Bank stock– It is not practical to determine the fair value of Federal Home Loan Bank stock and Federal Reserve Bank stock due to restrictions placed on its transferability.

Certificates of deposit - Fair values of certificates of deposit are estimated using discounted cash flow analyses using current market rates applied to the estimated life resulting in a Level 2 classification.

All other deposits- The fair values for all other deposits other than certificates of deposit are equal to the amount payable on demand (the carrying value) resulting in a Level 1 classification.

Securities sold under agreements to repurchase – The carrying amount of borrowings under repurchase agreements approximate their fair values resulting in a Level 2 classification.

Long-term borrowings – The fair value of long-term borrowings is estimated using discounted cash flow analyses based on current borrowing rates resulting in a Level 2 classification.

Subordinated debentures- The fair value of subordinated debentures is based on the rates currently available to the Company with similar term and remaining maturity and credit spread resulting in a Level 3 classification.

Standby letters of credit – The fair value of off-balance sheet items is based on the current fees and costs that would be charged to enter into or terminate such arrangements resulting in a Level 3 classification.

Accrued interest receivable/payable – The carrying amounts of accrued interest approximate fair value resulting in a Level 1, Level 2 or Level 3 classification which is consistent with its associated asset/liability.

**NOTE 9. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The following table summarizes the changes within each classification of accumulated other comprehensive income for the nine months ended September 30, 2012 and 2011: