Earning *customer relationships* for *160 years.*

Lyons Bancorp, Inc.

It's all about people.

2012 ANNUAL REPORT

PROFILE

Lyons Bancorp, Inc. is a bank holding company headquartered in Lyons, New York, with assets of $665 million at December 31, 2012. Lyons Bancorp, Inc. has one banking subsidiary, The Lyons National Bank.

The Lyons National Bank is a community bank with offices in Clyde, Lyons, Macedon, Newark, Ontario and Wolcott in Wayne County, Jordan in Onondaga County, Canandaigua and Geneva in Ontario County, Penn Yan in Yates County and Waterloo in Seneca County. The Lyons National Bank has one subsidiary, Lyons Realty Associates Corp.

ANNUAL MEETING

The annual meeting of the stockholders will take place at 4:30 p.m. on May 22, 2013 at the historic Ohmann Theatre in Lyons, NY.

STOCK SYMBOL

LYBC

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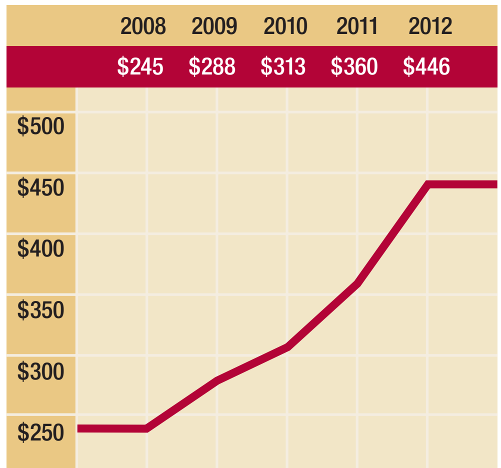
President's Message

In a speech in South Africa in 1890, Mahatma Gandhi is alleged to have said; *"A customer is the most important visitor on our premises. He is not dependent on us. We are dependent on him. He is not an interruption of our work. He is the purpose of it. He is not an outsider of our business. He is part of it. We are not doing him a favor by serving him. He is doing us a favor by giving us the opportunity to do so."* Whether Gandhi actually uttered these words is not all that important. What is important is these simple words form a philosophy well worth absorbing and placing at the center of all customer interactions. By extending warm, welcoming hospitality to customers with courtesy and attentiveness, rather than offering cool technical efficiency on a transactional basis, we get closer to the truth of what customer-satisfying service really is. Ultimately, when customers are satisfied, the potential for them to become loyal, long-term customers increases greatly. This philosophy is at the heart of our corporate culture, a culture which focuses on earning customer relationships – one at a time. The willingness of our staff to continue to embrace this culture and take it to new heights in 2012 helped us add 3,000 new customers to our banking family and over $100 million to our balance sheet. Never before have we experienced this type of growth, even in the years when we opened a branch office in a new market.

Total Gross Loans (millions)



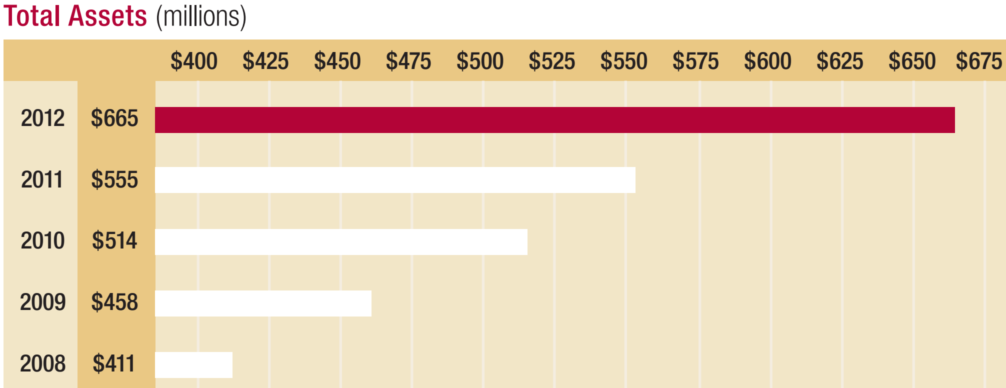
Our tremendous growth in 2012 was aided by being in the right place at the right time with a proven, successful, and sought-after brand of hometown banking when both a money center bank and a large regional bank exited our service area. In mid-2011, the regional bank purchased the Upstate New York retail branch network of the money center bank. Obviously, this dislodged and disturbed a large number of the former bank's customers. To add to the their anxiety, shortly after purchasing this network, the regional bank decided in late fall of 2011 to resell many of the branches it had just purchased. We quickly realized the opportunity these banks had presented to us as their customers soon became weary of the "Buffalo Shuffle". Always up for an extended challenge, our staff responded, and the rest is history.

Robert A. Schick

President & Chief Executive Officer Lyons Bancorp, Inc., and The Lyons National Bank

Diluted Earnings Per Share

Total Assets (millions)

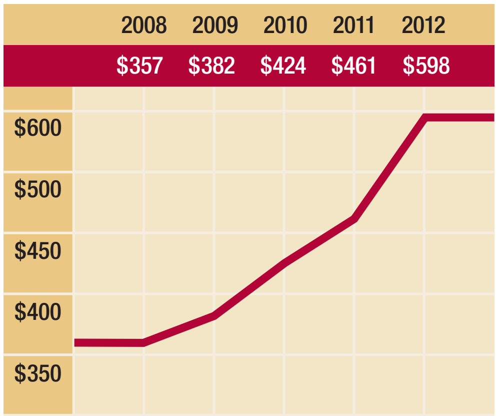


LNB Clyde Office Customers Enjoy the Branch's 10-Year Anniversary Celebration

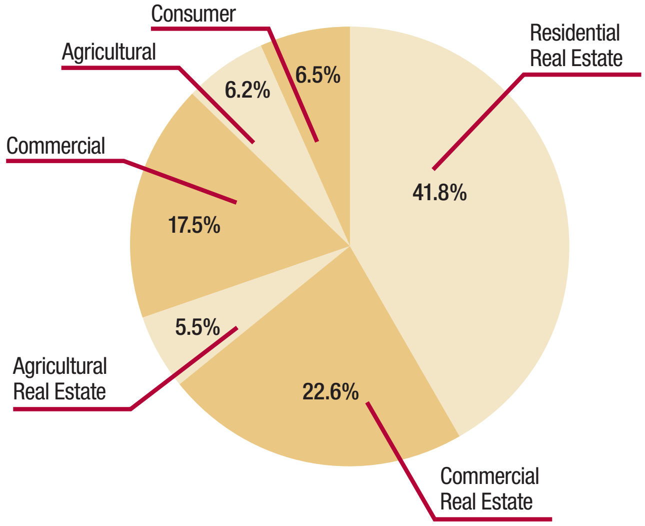
Bottom Row Left to Right: Cathi Tatich, Ken Disanto, Rebecca Odell. Top Row Left to Right: Jane Robert, David Odell.

President's Message CONTINUED

Total Deposits (millions)



Loan Diversification



The growth we experienced in customers and size drove our earnings to record levels for the 16th consecutive year. In 2012, we earned $6.17 million, an increase of 20% over our previous record in 2011. On a per share basis, and after considering the shares eligible for conversion associated with our outstanding trust preferred stock, our 3 for 2 stock split in February of 2012, and our equity offering in June of 2012, which increased the amount of our common shares by approximately 192,000, we earned $4.19 versus $3.76 in 2011. These record earnings afforded our Board the opportunity to once again raise our dividend – for the 14th consecutive year. In fact, the Board raised the dividend twice during 2012, once in February by $0.03 and again in December by $0.01. In addition, for the second time in three years, the Board declared and paid an additional $0.05 per share dividend at yearend. And suspecting the tax on dividends would be raised in 2013 (it was), the Board accelerated payment of the regular December quarterly dividend as well as the additional dividend into late 2012 to avoid the higher tax rate.

As we planned our growth strategies for 2012 to take advantage of the opportunity we were presented, we asked our shareholders to consider a few amendments to our corporate charter that would facilitate our expected growth. The first was to approve an increase in the number of authorized common shares to 5 million from 2 million. Another was to authorize the issuance of up to 5 thousand shares of convertible preferred stock. This second authorization has a sunset provision of December 31, 2014. The third was a recommendation to change the Company's name. We successfully made our case for all three of these changes as they were overwhelming approved by the shareholders in February. To date, no convertible preferred shares have been issued and after debating the issue again, we decided not to change our well-recognized name.

With the increased authorization of common shares and in preparation of a capital raise, the Board authorized a 3 for 2 common stock split. In response, our quoted market price was adjusted to $28 per share, a level more affordable for investors. This was the third time in the past 15 years the Board has taken this action. The first in 1997 was a 20 for 1 split that resulted in the quoted price moving from $425 to approximately $21 per share. In 2003, the Board split the shares again, this time 2 for 1, and finally last February 3 for 2. If you were fortunate enough to have owned one share prior to the 1997 split, that share has grown into 60 shares. Furthermore, with a quoted price as of the time of this writing of $40 per share, that $425 investment is now valued at $2,400; plus, we have been paying a steadily increasing dividend throughout those 15 years.

We embarked on an equity raise in late February in order to maintain our strong capitalization levels and support our expected growth. As I alluded to above, in June we raised $5 million of common equity capital, our sixth trip to the market in 12 years. The offering was extremely successful as we received approximately $12 million in orders for our stock. Because we initiated the offering (in February) under the supposedly streamlined and less costly guidance (Regulation "A") of the Securities and Exchange Act, we were limited to accepting $5 million in orders for our stock.

While tremendously successful, the offering provided much frustration as well. Midway through preparing the necessary documents for SEC review, the President, amid great fanfare in the Rose Garden, signed into law the "Jumpstart Our Business Startups" (JOBS) Act of 2012. During the signing ceremony the President was quoted as saying, "The JOBS Act reduces many of the regulatory barriers that have, up to this point, made it nearly impossible for young startups to raise much needed capital…this historic moment is going to redefine business as we know it.” This bill complemented our growth strategy because aside from its main premise to make it easier and cheaper for startups and small businesses to raise capital in order to grow, create jobs and spur the economy, a provision of the JOBS Act increased the amount of capital we could raise under Regulation “A” of the Securities Act to $50 million from $5 million. Sensing the demand for our shares, we were jubilant as we knew the added capital would strengthen our balance sheet more and allow for additional growth, the resulting earnings, and new jobs. That excitement quickly waned as we were told by the staff at the SEC that even though the JOBS Act was signed (April 6th) prior to the closing of our offering in June, it did not apply to us, and we could only accept $5 million in orders, not the whole $12 million. Their reasoning: internal SEC procedures had not been re-written (governmental departments have 270 days from the date a bill is signed into law to re-write appropriate internal procedures) and until they are, they will follow the current procedures. So much for all the fanfare. FYI, as of February 16, 2013, the internal procedures have still not been re-written. If you are counting, it’s been 316 days since the signing.

At the same time we were selling additional shares and courting new customers, we were deep into both a renovation as well as an expansion project in Lyons. Our Main Office in Lyons, built in 1929, was badly in need of a facelift. We worked closely with Village of Lyons officials to secure a $500 thousand “Main Street Grant” that was available to all businesses in Lyons to upgrade their buildings. With a portion of those funds, along with over $750 thousand of our own money, we replaced the magnificent arched windows, front stoop and pole lighting, repointed much of the exterior, refitted our famed boardroom with interactive technology, rewired the entire building, replaced a roof, addressed serious water problems and reconfigured and redecorated all of the second and third floor offices. Now the “lady” is all set for another 100 years.

Due to our growth, especially in our consumer loan and residential mortgage department, we needed additional office space to house our increasing staff. In May, we opened a new operations center on nearby Leach Road in Lyons. This bright, airy, wide-open space lends itself quite favorably to the efficient movement of people and information. We have since moved our accounting and commercial loan operations to this facility as well. When we opened the center we felt comfortable that we had enough additional space to facilitate our growth for two to three years. Not sure this is the case anymore; stay tuned.

In 2012, we aired our first television commercials. We did a series of 30-second spots featuring customers and staff and emphasizing our hometown approach to relationship banking. We received a great deal of positive feedback, and because of modern technology, you can view the commercials on your computer. Just click on the “community connections” tab on our website.

We introduced our mobile app, “Ready, Set, gomobile with LNB” in the autumn of 2012. Now you can conduct the same banking business on your iPhone, Android and BlackBerry that you have been doing for years online. It’s fast, easy, secure, convenient, and free. We’ll add a bill paying component later this year.

With mixed emotions, we said goodbye to long time employee Linda Wilkes. Linda retired after 38 years with LNB. She began her career as a bookkeeper and held many positions within that department and our IT department. Linda was a veteran of the many changes the Bank and our industry experienced during her tenure here. However, her commitment to provide excellent customer service never wavered.

Maria Pruner, our receptionist, also retired. She was the first friendly face you saw when you entered our Main Office Lobby. She was also the voice you heard when you called the office. We wish both Linda and Maria happiness and health in their retirement years. We’ll miss them both and hope they come back often to visit.

By all measurements 2012 was a very successful year for LNB. New customers continued to flock to our brand of hometown banking and delivery channels. With the help of these customers, we grew our balance sheet and profitability to unprecedented levels. We strengthened our already strong financial position by raising new capital and adding new shareholders. We kept pace with ever-changing banking technology and upgraded our facilities. While we are extremely proud of what we accomplished, we need to temper our pride and remind ourselves of a quote Mahatma Gandhi did articulate, “It is unwise to be too sure of one’s own wisdom. It is healthy to be reminded that the strongest might weaken and the wisest might err.”

Thank you for your continued support and confidence.

Robert A. Schick
President & Chief Executive Officer
Lyons Bancorp, Inc. & The Lyons National Bank

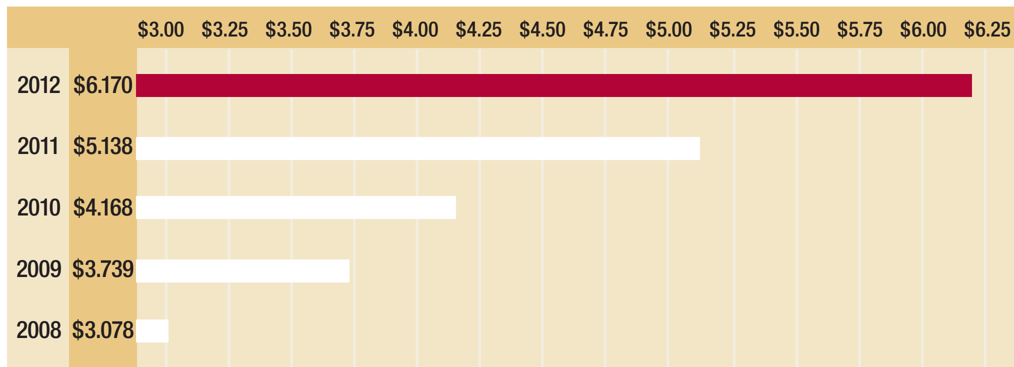
2012 Financial Highlights

Diana R. Johnson
Executive Vice President & Chief Financial Officer
Lyons Bancorp, Inc. and The Lyons National Bank

RESULTS OF OPERATIONS

For the year ended December 31, 2012, we recorded earnings of $6.2 million, an increase of $1.0 million or 20.1% over 2011. This translates into earnings per diluted share of $4.19 or an 11.4% increase year over year. Return on average assets was 0.99% versus 0.96% for 2011, and return on average equity was 14.91% versus 14.47% for 2011.

Net Income (year ending, in millions)



	2012			2011		
	Average Balance	**Interest Inc/Exp**	**Average Yield/Cost**	Average Balance	Interest Inc/Exp	Average Yield/Cost
Interest-earning assets:						
Loans:						
Residential real estate	**$ 163,822**	**$ 6,987**	**4.26%**	$ 127,526	$ 6,038	4.73%
Commercial and agriculture real estate	**112,387**	**5,906**	**5.26%**	98,813	5,212	5.27%
Commercial and agriculture loans	**94,225**	**4,508**	**4.78%**	75,171	3,716	4.94%
Consumer installment loans	**29,427**	**1,962**	**6.67%**	28,708	2,002	6.97%
Total loans	**399,861**	**19,363**	**4.84%**	330,218	16,968	5.14%
Investments	**167,032**	**4,463**	**2.67%**	162,408	4,870	3.00%
Federal funds sold and other interest-earning assets	**19,888**	**48**	**0.24%**	8,472	19	0.22%
Total interest-earning assets	**586,781**	**23,874**	**4.07%**	501,098	21,857	4.36%
Noninterest-earning assets	**38,695**			33,825		
Total assets	**$ 625,476**			$ 534,923		
Interest-bearing liabilities:						
Interest-bearing checking	**$ 55,894**	**$ 117**	**0.21%**	$ 50,092	$ 96	0.19%
Money market and savings accounts	**269,766**	**1,601**	**0.59%**	208,846	1,584	0.76%
Time deposits	**124,732**	**1,197**	**0.96%**	120,117	1,274	1.06%
Borrowings	**14,765**	**84**	**0.57%**	21,188	175	0.83%
Junior subordinated debentures	**9,217**	**557**	**6.04%**	9,217	524	5.69%
Total interest-bearing liabilities	**474,374**	**3,556**	**0.75%**	409,460	3,653	0.89%
Noninterest-bearing deposits	**102,682**			86,267		
Other noninterest-bearing liabilities	**7,033**			3,637		
Total liabilities	**584,089**			499,364		
Total equity	**41,387**			35,559		
Total liabilities and equity	**$ 625,476**			$ 534,923		
Net interest spread			**3.32%**			3.47%
Net interest income/margin on earning assets		**20,318**	**3.46%**		18,204	3.63%
Tax equivalent adjustment		**(727)**			(642)	
Net interest income per financial statements		**$ 19,591**			$ 17,562	

Our largest revenue source is net interest income, the difference between the interest income we earn on our interest-earning assets, primarily loans and investment securities, and the interest paid on our interest-bearing liabilities, primarily deposit accounts and borrowings. Net interest income for 2012 was $19.6 million, an increase of $2.0 million or 11.6% over 2011. This increase was due primarily to strong growth of our earning assets funded by steady deposit growth, as average earning assets increased $85.7 million or 17.1% during 2012, and average interest-bearing deposits increased $71.3 million or 18.8% year over year. However, our tax-equivalent margin decreased 17 basis points year over year, measuring 3.46% during 2012, compared to 3.63% in 2011. This decrease was due to lower reinvestment rates for loan and investment cash flows, while funding costs currently at low levels repriced more modestly.

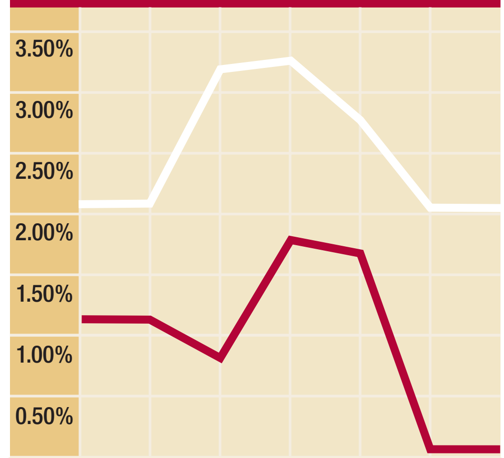
Our provisions for loan losses are based upon our assessment of a variety of factors, including loan credit quality, the general economic environment and growth in our loan portfolio. In 2012, we provided $450,000 for loan losses, compared to $965,000 in 2011. The decrease in the provision for 2012 is reflective of general improvement in our asset quality ratios. At December 31, 2012 our non-performing loans totaled 0.19% of total loans, as compared to 1.65% at December 31, 2011, and compared favorably to our peer's ratio of 2.05%. Our net charge offs to average loans during 2012 totaled 0.11%, compared to 0.12% during 2011 and 0.51% for our peers. The percent of our commercial and agriculture loan portfolio with an aggregate "pass" rating within our internal risk rating system improved from 88.9% in 2011 to 92.7% in 2012.

Noninterest income is an important revenue source for us, and consists primarily of service charges on deposit accounts, loan servicing fees, cardholder fees, financial services fees, gains and losses on the sale or impairment of securities, and gains on sale of loans. In 2012, noninterest income represented 24.9% of all revenue sources and totaled $6.5 million, an increase of $553,000 or 9.3% over 2011 levels. The majority of the increase was due to increased gains on sale of loans. In 2012, we sold $50.4 million in residential and commercial loans for gains of $1.6 million, as compared to sales of $38.8 million and gains of $743,000 in 2011. The increase in gains on sale of loans was tempered by reductions in other revenue sources, such as service charges on deposit accounts, financial services fees, net gains on sales of investments, and other income.

Noninterest expense consists primarily of compensation and employee benefits, occupancy and equipment expenses, advertising, data processing, professional fees, FDIC insurance, and other operating expenses. In 2012, total noninterest expense was $17.1 million, an increase of $1.5 million or 9.5% over 2011. Increases in salaries and wages totaled $746,000 and were primarily the result of annual wage increases and increased incentives and commissions earned by our employees, based on the strong balance sheet growth we experienced in 2012. Pension and other benefits expense increased $463,000 or 20.7% in 2012, due almost entirely to increased costs relating to our pension plan. Occupancy costs increased $102,000 or 5.9% year over year, due to the need for additional office space to support our continued growth. Most other operating expenses experienced modest increases in 2012 compared to 2011, with the exception of advertising expense, which increased 43.6% due to new initiatives such as television advertising.

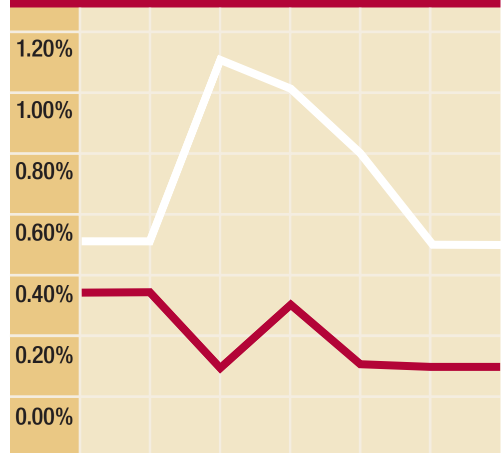
Nonaccruing Loans to Total Loans

	2008	2009	2010	2011	2012
LNB	1.09%	0.86%	1.79%	1.65%	0.19%
Peer	2.07%	3.18%	3.24%	2.78%	2.05%



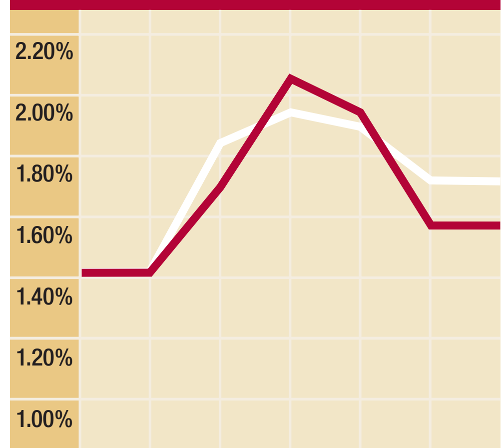
Net Charged-off Loans to Average Loans

	2008	2009	2010	2011	2012
LNB	0.35%	0.11%	0.30%	0.12%	0.11%
Peer	0.53%	1.12%	1.01%	0.80%	0.51%



Allowance for Loan Losses/Total Loans

	2008	2009	2010	2011	2012
LNB	1.41%	1.70%	2.06%	1.94%	1.57%
Peer	1.42%	1.85%	1.94%	1.90%	1.73%



2012 Financial Highlights *CONTINUED*

We proudly offer banking services to the City of Geneva and its residents.
Pictured (1st row-left to right) Tara Rago, Geneva Branch Manager; Matt Horn, City Manager; (2nd row) Jeff Friend, LNB VP / District Manager; and Ed George, City Comptroller.

LNB's breakthrough employee of the year.
Amanda Lawson, Credit Analyst (left) is congratulated by Pam Lee, VP and Phil McCann EVP/CCO.

LNB employees team up with the Wayne ARC Rimriders to face off against the Rochester Wheels.
Proceeds benefit programs of the Wayne ARC.

ANALYSIS OF FINANCIAL CONDITION

As Bob highlighted in his President's Message, we continued to experience solid loan and deposit growth during 2012, supported by a strong capital base that was further enhanced by a successful common stock offering during the second quarter 2012. Total assets on December 31, 2012 were $665.5 million, an increase of $110.0 million or 19.8% over December 31, 2011. Total equity at December 31, 2012 was $44.9 million, an increase of $9.0 million or 25.0% over December 31, 2011.

Total loans were $445.9 million at December 31, 2012, an increase of $86.0 million or 23.9% from December 31, 2011. We continued to support our strategy of balancing the loan portfolio more evenly between consumer and commercial loans, ending the year with 48% consumer-related loans versus 52% commercial-related loans, ratios essentially unchanged from the prior year. We are well positioned to continue prudent lending to the individuals, families and businesses here in our Upstate New York marketplace and look forward to another year of solid loan growth.

We maintain an investment portfolio to provide us with important liquidity considerations and earnings potential. Our investment portfolio consists primarily of United States Treasury bonds, United States Agency debt, mortgage-backed securities either guaranteed by the U.S. government or issued by the Federal Home Loan Bank, and state and local government debt. As of December 31, 2012, our investment portfolio totaled $174.8 million, an increase of $20.2 million over December 31, 2011 and had an average tax-equivalent yield of 2.67% during 2012. Substantially all of our investments are classified as available for sale, and may be used as collateral for public fund deposits.

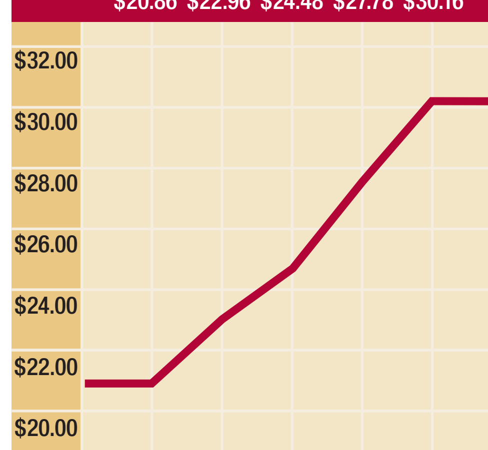
Deposits generated within our local markets are the major source of funds for our lending and investment activities. Total deposits at December 31, 2012 were $598.3 million, an increase of $137.3 million or 29.8% over December 31, 2011. We continued to experience strong growth in our core deposit base, with each branch increasing its presence in the community it serves, and most branches growing their base by 20% or more.

Total equity was $44.9 million at December 31, 2012, and reflects the result of our successful common stock offering, in which we raised $4.4 million after paying related expenses. Our Board of Directors is committed to providing a solid return to our shareholders and declared a total of $1.26 per share in dividends during 2012. This represents a yield of 3.65% based on our year end market price of $34.50 per share.

Please refer to our Consolidated Financial Report as of December 31, 2012 for more information regarding our 2012 results.

Book Value per Share

2008	2009	2010	2011	2012
$20.86	$22.96	$24.48	$27.78	$30.16



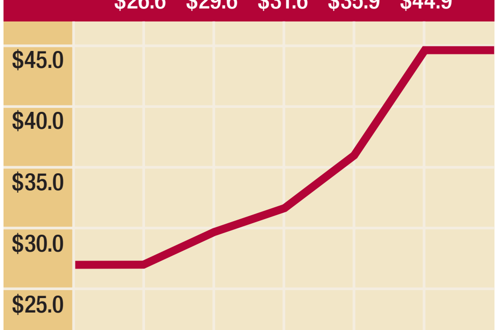
SELECTED FINANCIAL DATA

(In thousands, except per share data)	**2012**	2011	2010	2009	2008
	Year Ended December 31				
Financial Statement Highlights					
Assets	**$ 665,472**	$ 555,451	$ 513,585	$ 457,787	$ 411,490
Loans, gross	**445,906**	359,951	312,629	288,226	245,457
Deposits	**598,305**	460,999	424,006	382,334	356,767
Other borrowings	**5,000**	42,058	44,491	36,046	17,642
Junior subordinated debentures	**9,217**	9,217	9,217	6,190	6,190
Total equity	**44,884**	35,894	31,567	29,571	26,600
Interest and dividend income	**23,147**	21,215	20,819	19,829	20,788
Interest expense	**3,556**	3,653	3,730	4,692	7,286
Net interest income	**19,591**	17,562	17,089	15,137	13,502
Provision for loan losses	**450**	965	2,405	1,725	405
Net securities gains	**215**	407	727	811	71
Net income	**6,170**	5,138	4,168	3,739	3,078
Per Share Information (1)					
Basic earnings per share	**$ 4.43**	$ 3.98	$ 3.24	$ 2.93	$ 2.42
Cash dividends declared	**$ 1.26**	$ 0.95	$ 0.89	$ 0.79	$ 0.76
Book value per share	**$ 30.16**	$ 27.78	$ 24.48	$ 22.96	$ 20.86
Selected Ratios					
Return on average assets	**0.99%**	0.96%	0.85%	0.86%	0.79%
Return on average equity	**14.91%**	14.47%	12.99%	13.13%	11.93%
Leverage ratio (Bank)	**8.26%**	8.42%	8.22%	8.01%	8.32%
Dividend payout ratio	**34.98%**	22.75%	26.97%	26.64%	30.77%
Other Selected Data *(in whole numbers)*					
Employees (full time equivalent)	**155**	142	139	129	131
Banking Offices	**11**	11	10	10	10

(1) Per share data reflects 3-for-2 stock split in the form of a stock dividend on February 29, 2012.

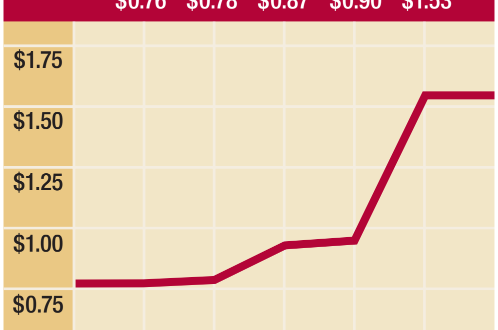
Total Equity (millions)

2008	2009	2010	2011	2012
$26.6	$29.6	$31.6	$35.9	$44.9



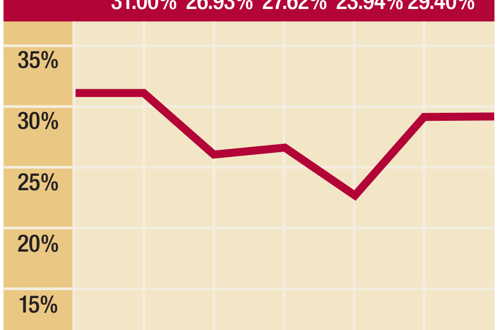
Annual Cash Dividend Paid

2008	2009	2010	2011	2012
$0.76	$0.78	$0.87	$0.90	$1.53



Dividends Declared to Net Income

2008	2009	2010	2011	2012
31.00%	26.93%	27.62%	23.94%	29.40%



Board of Directors

TOP ROW *(from left to right)*

Andrew F. Fredericksen, CPA Senior Partner, *Fredericksen & Sirianni, LLP*
Thomas L. Kime Executive Vice President & Chief Operating Officer, *The Lyons National Bank*
Joseph A. Fragnoli Owner, *Super Casuals*
Dale H. Hemminger President & General Manager, *Hemdale Farms & Greenhouses*
Robert A. Schick President & Chief Executive Officer, *Lyons Bancorp, Inc. & The Lyons National Bank*
David J. Breen, Jr. General Manager, *Herrema's Market Place*
Clair J. Britt, Jr. Executive Vice President & Senior Commercial Lending Officer, *The Lyons National Bank*
Brad A. Person President & General Manager, *Nuttall Golf Cars Inc. and Nuttall Golf Car Leasing, LLC*

BOTTOM ROW *(from left to right)*

James A. Homburger, Real Estate Broker
John J. Werner, Jr., Retired President & Chief Executive Officer, *Lyons Bancorp, Inc. & The Lyons National Bank*
James E. Santelli, Retired Vice President & Co-owner, *Santelli Lumber Co.*

Advisory Boards

GENEVA

Stephen J. Blowers
Blowers Agri Service, Inc.

Peter J. D'Amico, Jr.
D'Amico Chrysler Dodge Jeep

Jason S. Feinberg
Finger Lakes Health

Robert S. Flowers
Hobart and William Smith Colleges

Carl W. Fribolin
White Springs Winery

Bernard G. Lynch
Lynch Furniture

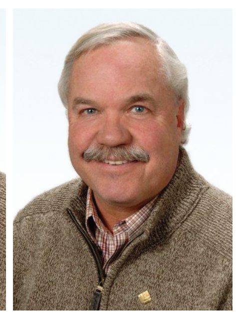
Anne D. Nenneau
CCN International

PENN YAN

Bonnie B. Curbeau
Curbeau Realty

Michael D. Linehan
Yates County Chamber of Commerce

James H. Long
Longs' Cards and Books



Paul W. Marble, Jr.
Marble's Automotive and Glass

Steven D. Perry
Knapp & Schlappi Lumber Co., Inc.

Neil J. Simmons
Simmons Vineyards

Not Pictured: **Henry H. Martin**
Town of Benton Dairy Farmer

SENECA COUNTY

Salvatore N. Franzone
Ciccino's Pizzeria and Restaurant

Kenneth W. Padgett
Retired President of NYCC, Ryan Chiropractic

Eugene Pierce
Glenora Wine Cellars, Inc. and Knapp Winery

Robert L. Sessler
Retired Business Owner

Jane M. Shaffer
Sessler Companies

Joyce N. Sinicropi
Sinicropi Florist

Stephen J. Wadhams
Wadhams Enterprises, Inc.

Executive Management

TOP ROW *(from left to right)*

Thomas L. Kime — *Executive Vice President & Chief Operating Officer*

Robert A. Schick — *President & Chief Executive Officer*

Stephen V. DeRaddo — *Executive Vice President & Senior Retail Lending Officer*

BOTTOM ROW *(from left to right)*

Clair J. Britt, Jr. — *Executive Vice President & Senior Commercial Lending Officer*

Diana R. Johnson — *Executive Vice President & Chief Financial Officer*

Phillip M. McCann — *Executive Vice President & Chief Credit Officer*

Bank Officers and Supervisors

ADMINISTRATION

Robert A. Schick
President & Chief Executive Officer

Thomas L. Kime
Executive Vice President & Chief Operating Officer

Carol A. Snook
Banking Officer & Corporate/Executive Secretary

AUDIT & COMPLIANCE

Ruth M. Columbus
Vice President & Director of Internal Audit

Joyce A. Marble
Assistant Vice President & Compliance/BSA Officer

Melonie L. Tiffany
Banking Officer & Staff Auditor

BRANCH DIVISION

Thomas D. Muller
Senior Vice President & Director of Retail Sales

Susan K. Andersen
Vice President & Branch Manager – Penn Yan

Jeffrey A. Friend
Vice President & District Branch Manager – Ontario and Seneca County

James S. Bilotta
Assistant Vice President & Branch Manager – Macedon

Jarrod D. Crawford
Assistant Vice President & Branch Manager – Newark

William L. Dungey
Assistant Vice President & Branch Manager – Clyde and Jordan

Jill D. Hansen
Assistant Vice President & Branch Manager – Seneca County

Tara R. Rago
Assistant Vice President & Branch Manager – Geneva

Sherri A. Sheldon
Assistant Vice President & Branch Manager – Wolcott

Jean E. Tsepas
Assistant Vice President & Branch Manager – Ontario

Kate E. Decker
Banking Officer & Assistant Branch Manager – Geneva

Cathy J. DeMay
Banking Officer & Assistant Branch Manager – Ontario

Julieann B. Downey
Banking Officer & Branch Manager – Lyons

Shannon K. Proper
Banking Officer & Business Development Cash Manager Rep.

Susan L. Snyder
Banking Officer & Assistant Branch Manager – Penn Yan

Kathleen A. Wind
Banking Officer & Assistant Branch Manager – Newark

COMMERCIAL LENDING DIVISION

Clair J. Britt, Jr.
Executive Vice President & Senior Commercial Lending Officer

Stephen V. D'Orazio
Vice President & Commercial Loan Officer

James H. King
Vice President & Commercial Loan Officer

Scott A. MacKenzie
Vice President & Agricultural /Commercial Loan Officer

Anna M. Bridger
Assistant Vice President & Commercial Loan Officer

Darrin Brentnall
Assistant Vice President & Commercial Loan Officer

Kevin P. Gallivan
Assistant Vice President & Commercial Loan Officer

Ryan M. Hallings
Assistant Vice President & Commercial/Agricultural Loan Officer

Gregory R. MacDonald
Assistant Vice President & Agricultural/Commercial Loan Officer

CREDIT ADMINISTRATION & COMMERCIAL LOAN OPERATIONS

Phillip M. McCann
Executive Vice President & Chief Credit Officer

Pamela J. Lee
Vice President & Portfolio Monitoring Officer

Jason Cornwell
Banking Officer & Senior Credit Underwriter

Amanda M. Lawson
Banking Officer & Credit Analyst

Lynnette M. Zelias
Banking Officer & Commercial Loan Operations Manager

FINANCE DIVISION

Diana R. Johnson
Executive Vice President & Chief Financial Officer

Brenda L. Cordero
Banking Officer & Accounting Manager

Chad J. Proper
Banking Officer & Financial Analyst

FINANCIAL SERVICES

Robert T. Koczent
Vice President & Director of Financial Services

HUMAN RESOURCES

Kimberly A. Kelley
Assistant Vice President & Director of Human Resources

Trevor Thomas
Assistant Vice President & Director of Training

MARKETING DIVISION

Shelly M. Nicoletta
Assistant Vice President & Director of Marketing

OPERATIONS & IT DIVISION

Todd F. Juffs
Assistant Vice President & MIS Officer

Cheryl M. Graham
Assistant Vice President & Policies and Procedures Manager

RETAIL LENDING DIVISION

Stephen V. DeRaddo
Executive Vice President & Senior Retail Lending Officer

Robert T. MacDonell
Vice President & Consumer Loan Officer

Joshua N. Miller
Vice President & Mortgage Underwriter

Hope A. Alexanian
Assistant Vice President & Retail Loan Operations Manager

Thomas R. David
Assistant Vice President & Mortgage Loan Officer

Timothy H. Lead
Assistant Vice President & Mortgage Underwriter

Joseph M. Arbogast
Banking Officer & Mortgage Originator

Angela M. Merola
Banking Officer & Collector

Jill I. Peek
Banking Officer & Mortgage Originator

SECURITY & FACILITIES DIVISION

Michael J. Colacino
Security & Banking Officer and Facilities Manager

A 160-Year Journey

A bank has occupied the corner of William and Church streets in Lyons since 1846. Pictured above is the Bank of Wayne, circa 1910, the location of our current Main Office, which underwent a major refurbishing in 2012 (pictured above and to the right).

HOW FAR WE'VE COME

LNB can trace its charter back to the Palmyra Bank of Lyons which was established in 1852. To foster a better relationship with the Village of Lyons, the Bank shortened its name to The Lyons Bank. Then in 1857 when it received its national charter, the bank's name was changed to its current moniker, The Lyons National Bank. When the Great Depression occurred seventy-five years later, LNB and the other bank in Lyons, The Gavitt National Bank were merged. The Lyons National Bank charter survived the merger but its offices were moved into The Gavitt National Bank's newly constructed office on the corner of William and Church Streets, LNB's present location. The newly consolidated bank had assets of $1.8 million and $180,000 in capital. Today, with 10 branches and the Main Office in 5 counties, the Bank has $665 million in assets and capital of $54 million.

2012 SUCCESSES

Our most successful year ever…

- 3,000 new LNB relationships
- Balance sheet growth of $100 million
- 16th consecutive year of earnings growth
- Another successful capital raise
- New operations center
- Enhanced technology delivery platform

LOOKING AHEAD

Our formula for success over the past 15 years has been constant and is built on four simple philosophies of: treating our employees with respect and as our most valuable assets, distinguishing ourselves from our peers by committing ourselves to providing outstanding customer service, being responsive to technology and a changing banking and economic environment, and growing strategically but measured. Why change a winning formula?

Clyde Office
4 Williams Street
Clyde, NY 14433
(315) 923-2100

Canandaigua Office
Roseland Center, Suite 65
3225 East Lake Rd
Canandaigua, NY 14424
(585) 394-BANK

Geneva Office
399 Exchange Street
Geneva, NY 14456
(315) 781-5000

Jordan Office
2 North Main Street
Jordan, NY 13080
(315) 689-9530

Lyons Office
Corner Routes 14 & 31
Lyons, NY 14489
(315) 946-4505

Macedon Office
359 NYS Route 31
Macedon, NY 14502
(315) 986-9681

Main Office
35 William Street
Lyons, NY 14489
(315) 946-4871

Newark Office
750 West Miller Street
Newark, NY 14513
(315) 331-0296

Ontario Office
Tops Plaza
6256 Furnace Road
Ontario, NY 14519
(315) 524-9661

Penn Yan Office
205 Liberty Street
Penn Yan, NY 14527
(315) 536-2300

Seneca County Office
2433 State Route 414
Waterloo, NY 13165
(315) 539-4100

Wolcott Office
5996 New Hartford Street
Wolcott, NY 14590
(315) 594-6002

BankwithLNB.com

Lyons Bancorp, Inc.
It's all about people.

Earning *customer relationships* for *160 years.*

Financial Report
December 31, 2012

Lyons Bancorp, Inc.
It's all about people.

ANNUAL MEETING

The annual meeting of the stockholders will take place at 4:30 p.m. on May 22, 2013 at the historic Ohmann Theatre in Lyons, New York.

Lyons Bancorp, Inc.

Consolidated Financial Report

December 31, 2012

Bonadio & Co., LLP
Certified Public Accountants

Table of Contents December 31, 2012 and 2011

Bonadio & Co., LLP
Certified Public Accountants

INDEPENDENT AUDITOR'S REPORT

March 8, 2013

To the Board of Directors and Stockholders of
Lyons Bancorp Inc.:

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

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

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

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

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

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

Bonadio & Co., LLP

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ALBANY • SYRACUSE
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GENEVA • UTICA

www.bonadio.com

Lyons Bancorp, Inc.

Consolidated Balance Sheets
December 31, 2012 and 2011

	2012	2011
Assets	(In thousands)	
Cash and due from banks	**$ 13,421**	$ 13,749
Interest-bearing deposits in banks	**7,661**	5,326
Cash and Cash Equivalents	**21,082**	19,075
Investment securities:		
Available for sale	**162,296**	143,080
Held to maturity	**8,593**	7,558
Restricted equity securities	**3,924**	4,001
Total Investment Securities	**174,813**	154,639
Loans	**445,906**	359,951
Less allowance for loan losses	**(7,000)**	(7,001)
Net Loans	**438,906**	352,950
Land, premises and equipment, net	**15,402**	14,696
Bank owned life insurance	**7,823**	7,593
Accrued interest receivable and other assets	**7,446**	6,498
Total Assets	**$ 665,472**	$ 555,451
Liabilities and Equity		
Liabilities		
Deposits:		
Interest-bearing	**$ 478,471**	$ 367,202
Non-interest-bearing	**119,834**	93,797
Total Deposits	**598,305**	460,999
Securities sold under agreements to repurchase	**-**	7,058
Borrowings from Federal Home Loan Bank	**5,000**	35,000
Junior subordinated debentures	**9,217**	9,217
Accrued interest payable and other liabilities	**8,066**	7,283
Total Liabilities	**620,588**	519,557
Equity		
Lyons Bancorp, Inc. stockholders' equity:		
Common stock	**747**	434
Paid-in capital	**12,181**	8,037
Retained earnings	**32,833**	28,477
Accumulated other comprehensive loss	**(711)**	(782)
Treasury stock, at cost	**(222)**	(328)
Total Lyons Bancorp, Inc. Stockholders' Equity	**44,828**	35,838
Noncontrolling interest	**56**	56
Total Equity	**44,884**	35,894
Total Liabilities and Equity	**$ 665,472**	$ 555,451

See notes to consolidated financial statements.

Consolidated Statements of Income
Years Ended December 31, 2012 and 2011

	2012	2011
	(In thousands, except per share data)	
Interest Income		
Loans	**$ 19,363**	$ 16,968
Investment securities:		
Taxable	**2,294**	2,923
Non-taxable	**1,490**	1,324
Total Interest Income	**23,147**	21,215
Interest Expense		
Deposits	**2,915**	2,954
Borrowings	**641**	699
Total Interest Expense	**3,556**	3,653
Net Interest Income	**19,591**	17,562
Provision for Loan Losses	**450**	965
Net Interest Income after Provision for Loan Losses	**19,141**	16,597
Noninterest Income		
Service charges on deposit accounts	**2,212**	2,344
Loan servicing fees	**613**	533
Cardholder fees	**913**	780
Financial services fees	**602**	669
Net realized gains from sales/calls of available for sale securities	**215**	407
Realized gains on loans sold	**1,603**	743
Earnings on investment in bank owned life insurance	**230**	235
Other	**117**	241
Total Noninterest Income	**6,505**	5,952
Noninterest Expense		
Salaries and wages	**7,545**	6,799
Pensions and benefits	**2,701**	2,238
Occupancy	**1,829**	1,727
Data processing	**1,136**	1,038
Professional fees	**823**	888
FDIC and OCC assessments	**524**	645
Advertising	**619**	431
Office supplies	**320**	314
Other	**1,635**	1,567
Total Noninterest Expense	**17,132**	15,647
Income before Income Taxes	**8,514**	6,902
Income Tax Expense	**2,340**	1,760
Net income attributable to noncontrolling interest and Lyons Bancorp, Inc.	**6,174**	5,142
Less: Net income attributable to noncontrolling interest	**4**	4
Net Income	**$ 6,170**	$ 5,138
Earnings Per Share – basic (1)	**$ 4.43**	$ 3.98
Earnings Per Share – diluted(1)	**$ 4.19**	$ 3.76

(1) *Per share amounts have been adjusted to reflect a 3-for2 stock split in the form of a stock dividend, effective February 29, 2012.*

See notes to consolidated financial statements.

Consolidated Statements of Comprehensive Income
Years Ended December 31, 2012 and 2011

	2012	2011
	(In thousands)	
Net income	**$ 6,170**	$ 5,138
Other comprehensive income:		
Securities available for sale:		
Changes in net unrealized gains during the year	**765**	3,591
Reclassification adjustment for gains included in income	**(215)**	(407)
Changes in unrealized gains during the year of restricted equity securities	**10**	-
Pension and postretirement benefits:		
Amortization of prior service (costs) credit	**(3)**	1
Amortization of net loss	**251**	104
Net actuarial loss	**(612)**	(2,175)
Change in net unrealized losses on the effective portion of cash flow hedge	**(78)**	(550)
	118	564
Tax expense	**(47)**	(225)
Other comprehensive income	**71**	339
Comprehensive income	**$ 6,241**	$ 5,477

See notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2012 and 2011

(In thousands, except per share data)

	Common Stock	Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Noncontrolling Interest	Total
Balance - January 1, 2011	$ 434	$ 7,932	$ 24,569	$ (1,121)	$ (303)	$ 56	$ 31,567
Net income attributable to noncontrolling interests and Lyons Bancorp, Inc.	-	-	5,138	-	-	4	5,142
Total other comprehensive income, net	-	-	-	339	-	-	339
Purchase of treasury stock	-	-	-	-	(330)	-	(330)
Issuance of treasury stock	-	52	-	-	212	-	264
Deferred compensation shares awarded, net	-	53	-	-	92	-	145
Deferred compensation shares vested	-	-	-	-	1	-	1
Dividends to noncontrolling interests	-	-	-	-	-	(4)	(4)
Cash dividends declared, $0.89 [1] per share	-	-	(1,230)	-	-	-	(1,230)
Balance – December 31, 2011	434	8,037	28,477	(782)	(328)	56	$ 35,894
Net income attributable to noncontrolling interests and Lyons Bancorp, Inc.	-	-	6,170	-	-	4	6,174
Total other comprehensive income, net	-	-	-	71	-	-	71
3-for-2 stock split in the form of a stock dividend	217	(217)	-	-	-	-	-
Issuance of common stock, net	96	4,333	-	-	-	-	4,429
Purchase of treasury stock	-	-	-	-	(241)	-	(241)
Issuance of treasury stock	-	2	-	-	210	-	212
Deferred compensation shares awarded, net	-	26	-	-	135	-	161
Deferred compensation shares vested	-	-	-	-	2	-	2
Dividends to noncontrolling interests	-	-	-	-	-	(4)	(4)
Cash dividends declared, $1.26 per share	-	-	(1,814)	-	-	-	(1,814)
Balance – December 31, 2012	$ 747	$ 12,181	$ 32,833	$ (711)	$ (222)	$ 56	$ 44,884

(1) Per share amounts have been adjusted to reflect a 3-for2 stock split in the form of a stock dividend, effective February 29, 2012.

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Years Ended December 31, 2012 and 2011

	2012	2011
	(In thousands)	
Cash Flows from Operating Activities		
Net income	**$ 6,170**	$ 5,138
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**450**	965
Earnings on investment in bank owned life insurance	**(230)**	(235)
Net realized gain from sales/calls of available for sale securities	**(215)**	(407)
Realized gains on loans sold	**(1,603)**	(743)
Gain on sale of real estate owned	**-**	(72)
Deferred compensation expense	**189**	148
Net amortization on securities	**1,135**	1,238
Depreciation and amortization	**874**	756
Deferred income tax benefit	**(62)**	-
Contribution to defined benefit pension plan	**(1,000)**	(750)
(Increase) decrease in accrued interest receivable and other assets	**(1,016)**	2,247
Increase in accrued interest payable and other liabilities	**1,762**	434
Loans originated for sale	**(49,392)**	(41,763)
Proceeds from sales of loans	**50,429**	38,799
Net Cash Provided by Operating Activities	**7,491**	5,755
Cash Flows from Investing Activities		
Purchases of securities available for sale	**(68,805)**	(38,449)
Proceeds from sales of securities available for sale	**13,695**	13,620
Proceeds from maturities and calls of securities available for sale	**35,524**	38,448
Purchases of held to maturity securities	**(5,182)**	(5,685)
Proceeds from maturities of securities held to maturity	**4,147**	3,383
Net (increase) decrease in restricted equity securities	**87**	(1,052)
Net increase in loans	**(85,840)**	(44,024)
Proceeds from sale of real estate owned	**-**	169
Premises and equipment purchases, net	**(1,600)**	(2,094)
Net Cash Used in Investing Activities	**(107,974)**	(35,684)
Cash Flows from Financing Activities		
Net increase in demand and savings deposits	**124,309**	39,931
Net increase (decrease) in time deposits	**12,997**	(2,938)
Net decrease in securities sold under agreements to repurchase	**(7,058)**	(633)
Net decrease in overnight borrowings from Federal Home Loan Bank	**(10,000)**	(10,800)
Proceeds received from term borrowings from Federal Home Loan Bank	**-**	15,000
Repayment of term borrowings from Federal Home Loan Bank	**(20,000)**	(6,000)
Net proceeds from sale of stock	**4,429**	-
Purchase of treasury stock	**(241)**	(330)
Issuance of treasury stock	**212**	264
Dividends paid	**(2,158)**	(1,169)
Net Cash Provided by Financing Activities	**102,490**	33,325
Net Increase in Cash and Cash Equivalents	**2,007**	3,396
Cash and Cash Equivalents – Beginning	**19,075**	15,679
Cash and Cash Equivalents – Ending	**$ 21,082**	$ 19,075
Supplementary Cash Flow Information		
Interest paid	**$ 3,564**	$ 3,682
Income taxes paid, net of refund received	**$ 2,951**	$ 1,337
Non-cash Disclosure		
Transfer of loans to foreclosed real estate	**$ -**	$ 4

See notes to consolidated financial statements.

Note 1 - Summary of Significant Accounting Policies

Nature of Operations

Lyons Bancorp, Inc. (the Company) provides a full range of commercial and retail banking services to individual and small business customers through its wholly-owned subsidiary, The Lyons National Bank (the Bank). The Bank's operations are conducted in eleven branches located in Wayne, Onondaga, Yates, Ontario, and Seneca Counties, New York. The Company and the Bank are subject to the regulations of certain federal agencies and undergo periodic examinations by those regulatory authorities.

The Company owns all of the voting common shares of Lyons Capital Statutory Trust I (Trust I), Lyons Capital Statutory Trust II (Trust II) and Lyons Statutory Trust III (Trust III). Trust I was formed in 2003, Trust II was formed in 2004, and Trust III was formed in 2009. The Trusts were each formed for the purpose of securitizing trust preferred securities, the proceeds of which were advanced to the Company and contributed to the Bank as additional capital.

The Bank owns all of the voting stock of Lyons Realty Associates Corp. (LRAC) and, prior to December 2011, LNB Life Agency, Inc. (LNB Life). LRAC is a real estate investment trust which holds a portfolio of real estate mortgages. In order to maintain its status as a real estate investment trust, LRAC holds the real estate mortgages until they are paid. The real estate mortgages held by LRAC are included in loans on the consolidated balance sheet. LNB Life provided non-insured financial services and products to the Bank’s customers. LNB Life was dissolved in December 2011 as the Bank discontinued offering these products and services to customers.

Basis of Consolidation

The consolidated financial statements include the accounts of the Company, the Bank, LRAC and LNB Life. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accounts of Trust I, Trust II, and Trust III are not included in the consolidated financial statements as discussed in Note 9.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near future relate to the determination of the allowance and provision for loan losses, actuarial assumptions associated with the Company’s benefit plans and deferred tax assets and liabilities.

Note 1 - Summary of Significant Accounting Policies (Continued)

Recently Issued Accounting Pronouncements

In April 2011, the FASB issued ASU No. 2011-03, *Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements.* This Update revises the criteria for assessing effective control for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The determination of whether the transfer of a financial asset subject to a repurchase agreement is a sale is based, in part, on whether the entity maintains effective control over the financial asset. This Update removes from the assessment of effective control: the criterion requiring the transferor to have the ability to repurchase or redeem the financial asset on substantially the agreed terms, even in the event of default by the transferee, and the related requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. The amendments in this Update are effective for interim and annual reporting periods beginning on or after December 15, 2011. The amendments are applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date and early adoption is permitted. The adoption of this guidance did not have a material impact on the Company's consolidated financial condition or result of operations.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS.* The update clarifies and expands the disclosures pertaining to unobservable inputs used in Level 3 fair value measurements, including the disclosure of quantitative information related to (1) the valuation processes used, (2) the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, and (3) use of a nonfinancial asset in a way that differs from the asset's highest and best use. The amendments are effective for annual periods beginning after December 15, 2011. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 amends the disclosure requirements for the presentation of comprehensive income, with no change in measurement. The amended guidance eliminates the option to present components of other comprehensive income (OCI) as part of the statement of changes in stockholders' equity. Under the amended guidance, all changes in comprehensive income are to be presented either in a single continuous statement of comprehensive income or in two separate but consecutive financial statements. The changes are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, with retrospective application required. See the Consolidated Statements of Comprehensive Income.

Note 1 - Summary of Significant Accounting Policies (Continued)

Investment Securities

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them until maturity. Securities to be held for indefinite periods of time are classified as available for sale and carried at fair value, with the unrealized holding gains and losses reported as a component of other comprehensive income, net of tax. Securities held for resale for liquidity purposes are classified as trading and are carried at fair value, with changes in unrealized holding gains and losses included in income. Management determines the appropriate classification of securities at the time of purchase. Restricted equity securities consist primarily of Federal Reserve Bank and the Federal Home Loan Bank stock.

Purchase premiums and discounts are recognized in interest income using the interest method or methods that approximate the interest method over the terms of the securities. Interest and dividends on securities are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are determined using the specific identification method.

On a quarterly basis, the Company performs an assessment to determine whether there have been any events or economic circumstances indicating that a security with an unrealized loss has suffered other-than-temporary impairment. A security is considered impaired if the fair value is less than its amortized cost basis at the reporting date. If impaired, the Company then assesses whether the unrealized loss is other-than-temporary. The assessment considers (i) whether the Company intends to sell the security prior to recovery and/or maturity, (ii) whether it is more likely than not that the Company will have to sell the security prior to recovery and/or maturity and (iii) if the present value of the expected cash flows is not sufficient to recover the entire amortized cost basis. If a debt security is deemed to be other-than-temporarily impaired, the credit loss component of an other-than-temporary impairment write-down is recorded in earnings while the remaining portion of the impairment loss is recognized, net of tax, in other comprehensive income provided that the Company does not intend to sell the underlying security and it is more-likely-than not that the Company would not have to sell the security prior to recovery.

Note 1 - Summary of Significant Accounting Policies (Continued)

Investment Securities - continued

The Company considers the following factors in determining whether a credit loss exists and the period over which the security is expected to recover:

- The length of time and the extent to which the fair value has been less than the amortized cost basis;
- The level of credit enhancement provided by the structure which includes, but is not limited to, credit subordination positions, excess spreads, overcollateralization, protective triggers;
- Changes in the near term prospects of the issuer or underlying collateral of a security, such as changes in default rates, loss severities given default and significant changes in prepayment assumptions;
- The level of excess cash flow generated from the underlying collateral supporting the principal and interest payments of the debt securities; and
- Any adverse change to the credit conditions of the issuer of the security such as credit downgrades by the rating agencies.

Loans

The Bank grants real estate, commercial and consumer loans to its customers. A substantial portion of the loan portfolio is represented by real estate loans in Wayne, Ontario, Yates, Onondaga, and Seneca Counties. The Company's loan portfolio includes residential real estate, commercial real estate, agricultural real estate, commercial and agricultural loans, and consumer installment classes. Residential real estate loans include classes for 1-4 family and home equity loans. Consumer installment loans include classes for direct and indirect loans.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Bank is generally amortizing these amounts over the contractual life of the loan. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective yield method.

Interest income is accrued on the unpaid principal balance. The accrual of interest on loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income or the allowance for loan losses if the interest income was earned in a prior period. The interest on these loans is accounted for on the cash-basis or cost-recovery method,

Note 1 - Summary of Significant Accounting Policies (Continued)

Loans - continued

until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Management, considering current information and events regarding the borrowers' ability to repay their obligations, considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is considered to be impaired, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or at the loan's observable fair value or the fair value of underlying collateral if the loan is collateral-dependent. Impairment losses are included in the allowance for loan losses through a charge to the provision for loan losses. Cash receipts on impaired loans are generally applied to reduce the principal balance outstanding. In considering loans for evaluation of impairment, management generally excludes smaller balance, homogeneous loans: residential mortgage loans, home equity loans, and all consumer loans, unless subject to a troubled debt restructuring. These loans are collectively evaluated for risk of loss.

Loans Held for Sale

Generally, loans held for sale consist of residential mortgage loans that are originated and are intended to be sold through agreements the Bank has with the Federal Home Loan Bank (FHLB) and the Federal Home Loan Mortgage Corporation (Freddie Mac). From time to time, the Bank may also hold commercial loans for sale. Realized gains and losses on sales are computed using the specific identification method. These loans are carried on the consolidated balance sheet at the lower of cost or estimated fair value determined in the aggregate. Loans held for sale totaled $5.1 million and $4.6 million at December 31, 2012 and 2011, respectively, and are included in loans on the consolidated balance sheets.

During 2012 and 2011, the Company sold residential mortgage loans totaling $50.4 million and $38.8 million, respectively, and realized gains on these sales were $1.6 million and $743,000, respectively. These residential real estate loans are generally sold without recourse in accordance with standard secondary market loan sale agreements. When residential mortgage loans are sold, the Company typically retains all servicing rights, which provides the Company with a source of fee income. In connection with the sales in 2012 and 2011, the Company recorded mortgage-servicing assets of $292,000 and $225,000, respectively. Amortization of mortgage-servicing assets amounted to $249,000 in 2012 and $185,000 in 2011. Net mortgage-servicing assets included in the consolidated balance sheets totaled $505,000 and $462,000 net of amortization, as of December 31, 2012 and 2011, respectively. Total loans serviced for others amounted to $150.6 million and $136.1 million at December 31, 2012 and 2011, respectively.

Allowance for Loan Losses

The allowance for loan losses (allowance) is established as losses are estimated to have occurred in the loan portfolio. The allowance is recorded through a provision for loan losses charged to earnings.

Note 1 - Summary of Significant Accounting Policies (Continued)

Allowance for Loan Losses - continued

Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of general, specific and unallocated components as further described below.

General Component

The general component of the allowance is based on historical loss experience adjusted for qualitative factors stratified by the following loan classes: residential real estate, commercial real estate, agriculture real estate, commercial and agricultural loans, and consumer installment segments. Management uses a rolling average of historical losses based on a time frame appropriate to capture relevant loss data for each loan class. The historical loss factor is adjusted for the following qualitative factors: levels and trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; and national and local economic trends and conditions. There were no changes in the Company's policies or its methodology pertaining to the general component of the allowance during 2012 or 2011.

The qualitative factors are determined based on the various risk characteristics of each loan type. Risk characteristics relevant to each loan type are as follows:

Residential real estate - The Company generally does not originate loans with a loan-to-value ratio greater than 80 percent and does not grant subprime loans. The majority of loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this class.

Commercial real estate - Loans in this class represent both extensions of credit for owner-occupied real estate and income-producing properties throughout the local region. The underlying cash flows of the operating commercial businesses (owner-occupied) and income properties (non-owner occupied) can be adversely impacted by a downturn in the economy as evidenced by increased vacancy rates, which in turn, will have an effect on the credit quality in this class. In a majority of cases, the Company obtains rent rolls annually and continually monitors the cash flows of non-owner occupied loans commensurate with sound lending practices.

Agricultural real estate – Loans in this class represent extensions of credit for owner-occupied agricultural real estate throughout the local region. The underlying cash flows generated by the agribusinesses can be adversely impacted by adverse climate and a weakened economy, which in

Note 1 - Summary of Significant Accounting Policies (Continued)

Allowance for Loan Losses - continued

turn, will have an effect on the credit quality in this class. Management obtains annual tax returns and continually monitors the cash flows of these loans commensurate with sound lending practices.

Commercial and Agricultural loans – Loans in these classes are made to businesses and generally secured by the assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer spending, will have an effect on the credit quality in this class.

Consumer installment loans – Loans in this segment may be secured or unsecured and repayment is dependent on the credit quality of the individual borrower. Unemployment rates will have an effect on the credit quality in this class.

Specific Component

The specific component relates to loans that are classified as impaired. Impairment is measured on a loan by loan basis for commercial and agricultural loans, commercial real estate and agricultural real estate by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral, less costs to sell, if determined to be more appropriate. An allowance is established when the discounted cash flow or collateral value of the impaired loan is lower than the carrying value of that loan. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer or residential real estate loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring agreement.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due.

All impaired loans require appraisals and/or chattel evaluations within 180 days of impairment, unless existing evaluation is less than 24 months old and no market or physical deterioration is noted. Re-appraisals and/or re-evaluations are conducted whenever deemed appropriate, but typically performed on a 24 month cycle if repayment is predicated upon liquidation of collateral and evidence suggests collateral values may have deteriorated.

Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines that significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reason for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Note 1 - Summary of Significant Accounting Policies (Continued)

Allowance for Loan Losses - continued

Unallocated Component

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general reserves in the portfolio.

Troubled Debt Restructurings

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. Loans modified in a TDR often involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor.

All of the loans identified as TDRs by the Company in 2012 and 2011 were previously on nonaccrual status and reported as impaired loans prior to restructuring. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time of at least six months. The TDR classification did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific allowance both before and after restructuring.

Land, Premises and Equipment

Land is stated at cost. Premises and equipment are recorded at cost and are generally depreciated by the straight-line method over the estimated useful lives of the assets. Buildings are generally depreciated over a useful life of thirty nine and one half years, furniture and equipment over a useful life of three to seven years, and leasehold improvements over the lesser of the asset's useful life or the term of the lease.

Bank Owned Life Insurance

Bank owned life insurance (BOLI) was purchased by the Bank as a financing tool for employee benefits and to fund discriminatory retirement benefits for the Board of Directors and executive management. The value of life insurance financing is the tax preferred status of increases in life insurance cash values and death benefits and the cash flow generated at the death of the insured. The proceeds or increases in cash surrender value of the life insurance policy results in tax-exempt income to the Company. The largest risk to the BOLI program is credit risk of the insurance carriers. To mitigate this risk, annual financial condition reviews are completed on all carriers. BOLI is stated on the Company's consolidated balance sheets at its current cash surrender value. Increases in BOLI's cash surrender value are reported as noninterest income in the Company's consolidated statements of income.

Note 1 - Summary of Significant Accounting Policies (Continued)

Foreclosed Real Estate

Included in other assets are real estate properties acquired through, or in lieu of, loan foreclosure. These properties are initially recorded at fair value less estimated selling costs at the date of foreclosure. Any write-downs based on the asset's fair value at date of foreclosure are charged to the allowance for loan losses. After foreclosure, property held for sale is carried at the lower of the new basis or fair value less any costs to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of the property to the lower of its cost or fair value less cost to sell. There was no foreclosed real estate at December 31, 2012 or 2011.

Treasury Stock

Treasury stock is recorded at cost. Shares are reissued on the average cost method, except for issuance of deferred compensation shares, which are discussed in Note 12.

Interest Rate Swap Agreement

The Company utilizes an interest rate swap agreement as part of its management of interest rate risk to modify the repricing characteristics of its floating-rate junior subordinate debentures. For this swap agreement, amounts receivable or payable are recognized as accrued under the terms of the agreement, and the net differential is recorded as an adjustment to interest expense of the related debentures. The interest rate swap agreement is designated as a cash flow hedge. Therefore, the effective portion of the swap's unrealized gain or loss was initially recorded as a component of other comprehensive income, net of tax. The ineffective portion of the unrealized gain or loss, if any, is immediately reported in other operating income. The Company considers its interest rate swap agreement to be fully effective and accordingly it has not recorded any gains or losses in earnings during 2012 or 2011.

Advertising Costs

Advertising costs are expensed as incurred.

Noncontrolling Interest

Noncontrolling interest represents the portion of ownership and interest expense that is attributable to the minority owners of LRAC. The minority ownership is in the form of 8.50% cumulative preferred stock, and the dividends paid are included in noncontrolling interest as a charge against income.

Income Taxes

Income taxes are provided for the tax effects of certain transactions reported in the consolidated financial statements. Income taxes consist of taxes currently due plus deferred taxes related primarily to temporary differences between the financial reporting and income tax basis of available for sale securities, the allowance for loan losses, premises and equipment, and prepaid and accrued employee benefits. The deferred tax assets and liabilities represent the future tax return consequences of the temporary differences, which will either be taxable or deductible when the assets and liabilities are

Note 1 - Summary of Significant Accounting Policies (Continued)

Income Taxes - continued

recovered or settled. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The Company recognizes interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Earnings Income Per Share

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as adjustments to net income for interest expense relating to convertible securities, net of tax, that would result from the assumed issuance. Treasury shares are not deemed outstanding for earnings per share calculations. See Note 13 for earnings per share calculations.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Statements of Cash Flows

For the purpose of presentation in the consolidated statements of cash flows, cash and cash equivalents are defined as the sum of cash and due from banks, federal funds sold, and interest-bearing deposits in banks with an original maturity of less than three months.

Off-Balance-Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the consolidated financial statements when they are funded or related fees are incurred or received.

Note 1 - Summary of Significant Accounting Policies (Continued)

Segment Reporting

The Company has evaluated the activities relating to its strategic business units, and determined that these strategic business units are similar in nature, and managed accordingly. The strategic business units are not reviewed separately to make operating decisions or assess performance. Therefore, the Company has determined it has no reportable segments.

Note 2 - Restrictions on Cash and Due from Banks

The Bank is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The required reserve at December 31, 2012 and 2011 was $11.8 million and $8.0 million, respectively.

The Bank is also required to maintain clearing balance funds on deposit with the Federal Reserve Bank. The required minimum clearing balance at December 31, 2012 and 2011 was zero and $600,000, respectively.

Note 3 - Investments

The amortized cost and fair value of investment securities, with gross unrealized gains and losses, are as follows at December 31, 2012 and 2011:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2012:				
Available for Sale:				
United States treasuries	$ 10,021	$ 126	$ (20)	$ 10,127
United States agencies	44,982	1,802	(16)	46,768
State and local governments	59,783	1,481	(51)	61,213
Mortgage-backed securities	43,277	912	(1)	44,188
Total Available for Sale	$ 158,063	$ 4,321	$ (88)	$ 162,296
Held to Maturity:				
Local governments	$ 8,593	$ -	$ -	$ 8,593
Restricted Equity Securities	$ 3,914	$ 10	$ -	$ 3,924

Note 3 – Investments (Continued)

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2011:				
Available for Sale:				
United States treasuries	$ 5,066	$ 89	$ -	$ 5,155
United States agencies	29,639	1,173	-	30,812
State and local governments	49,933	1,476	-	51,409
Mortgage-backed securities	54,759	954	(9)	55,704
Total Available for Sale	$ 139,397	$ 3,692	$ (9)	$ 143,080
Held to Maturity:				
Local governments	$ 7,558	$ -	$ -	$ 7,558
Restricted Equity Securities	$ 4,001	$ -	$ -	$ 4,001

All of the above mortgage-backed securities are residential direct pass through securities or collateralized mortgage obligations issued or backed by government sponsored enterprises (GSEs). Restricted equity securities primarily include non-marketable Federal Home Loan Bank New York (FHLBNY) stock and non-marketable Federal Reserve Bank (FRB) stock, both of which are required to be held for regulatory purposes and for borrowing availability. The required investment in FHLBNY stock is tied to both the Company's borrowing levels with the FHLB and commitments to sell residential mortgage loans to the FHLB. Holdings of FHLBNY stock and FRB stock totaled $3.0 million and $500,000 at December 31, 2012, respectively, and $3.2 million and $380,000 at December 31, 2011, respectively. These securities are carried at par, which is also cost. The Company has an investment in Federal Agricultural Mortgage Corp (Farmer Mac) class A stock totaling $51,000, in order to participate in certain lending activities with Farmer Mac. The stock is actively traded on the NYSE, pays a dividend, and is reflective of current market value. Restricted equity securities also include miscellaneous investments carried at par, which is also cost.

Restricted equity securities are held as a long-term investment and value is determined based on the ultimate recoverability of the par value. Impairment of these investments is evaluated quarterly and is a matter of judgment that reflects management's view of the issuer's long-term performance, which includes factors such as the following: its operating performance; the severity and duration of declines in the fair value of its net assets related to its capital stock amount; its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance; and its liquidity and funding position. After evaluating these considerations, the Company concluded that the par value of these investments will be recovered and, as such, has not recognized any impairment on its holdings of restricted equity securities during the current year.

Note 3 – Investments (Continued)

The following table sets forth the Company's investment in securities with unrealized losses of less than twelve months and unrealized losses of twelve months or more at December 31:

	Less than 12 Months		12 Months or More		Total	
(In thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2012:						
United States treasuries	$ 4,948	$ 20	$ -	$ -	$ 4,948	$ 20
United States agencies	2,984	16	-	-	2,984	16
State and local governments	5,150	51	-	-	5,150	51
Mortgage-backed securities	3,271	1	-	-	3,271	1
	$ 16,353	$ 88	$ -	$ -	$ 16,353	$ 88

	Less than 12 Months		12 Months or More		Total	
(In thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2011:						
Mortgage-backed securities	$ 4,380	$ 9	$ -	$ -	$ 4,380	$ 9
	$ 4,380	$ 9	$ -	$ -	$ 4,380	$ 9

On a quarterly basis, the Company performs an assessment to determine whether there have been any events or economic circumstances indicating that a security with an unrealized loss has suffered other-than-temporary impairment. Consideration is given to (1) the length of time and the extent to which the fair value has been less than the amortized cost basis, (2) the financial condition of the issuer (and guarantor, if any) and adverse conditions specifically related to the security, industry or geographic area, (3) failure of the issuer of the security to make scheduled interest or principal payments, (4) any changes to the rating of a security by a rating agency, (5) the presence of credit enhancements, if any, including the guarantee of the federal government or any of its agencies, (6) whether the Company intends to sell or more likely than not be required to sell the debt security, and (7) if the present value of the expected cash flow is not sufficient to recover the entire amortized cost.

There were eleven securities with unrealized losses for less than twelve months at December 31, 2012, while at December 31, 2011 there were two securities with losses for less than twelve. Substantially all of the unrealized losses on the Company's securities were caused by market interest rate changes from those in effect when the securities were purchased by the Company. The contractual terms of these securities do not permit the issuer to settle the securities at a price less than par value. Except for certain state and local government obligations, all securities rated by an independent rating agency carry an investment grade

Note 3 – Investments (Continued)

rating. Financial information relating to unrated state and government obligations is reviewed for indications of adverse conditions that may indicate other-than-temporary impairment. Because the Company does not intend to sell the securities with unrealized losses and it believes it is not likely to be required to sell the securities before recovery of their amortized cost basis, which may be, and is likely to be, maturity, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2012. In addition, there were no other-than-temporarily impairment charges in 2012 and 2011.

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

(In thousands)	**Available for Sale**		**Held to Maturity**	
	Amortized Cost	**Fair Value**	**Amortized Cost**	**Fair Value**
Due in one year or less	**$ 10,477**	**$ 10,563**	**$ 4,369**	**$ 4,369**
Due after one year through five years	**49,397**	**50,717**	**1,683**	**1,683**
Due after five years through ten years	**48,010**	**49,890**	**1,021**	**1,021**
Due after ten years	**6,902**	**6,938**	**1,520**	**1,520**
Securities not due at a single maturity date	**43,277**	**44,188**	**-**	**-**
	$ 158,063	**$ 162,296**	**$ 8,593**	**$ 8,593**

During 2012, the Company sold $13.7 million of available for sale securities, while in 2011 the Company sold $13.6 million of available for sale securities. Gross gains on the sales of investments in 2012 were $215,000. Gross gains on the sales of investment securities in 2011 were $407,000. Investment securities with carrying amounts of $122.4 million and $100.0 million at December 31, 2012 and 2011, respectively, were pledged to secure deposits as required or permitted by law.

Note 4 – Loans

Loans consist of the following at December 31, 2012 and 2011:

	2012	2011
	(In thousands)	
Real estate:		
Residential:		
1-4 family	**$ 125,766**	$ 91,883
Home equity	**60,578**	51,800
Commercial	**100,775**	84,193
Agriculture	**24,405**	20,839
Total mortgage loans on real estate	**311,524**	248,715
Commercial loans	**77,837**	58,778
Agriculture loans	**27,580**	23,024
Consumer installment loans:		
Direct	**14,564**	14,413
Indirect	**14,401**	15,021
Total consumer installment loans	**28,965**	29,434
Total loans	**$ 445,906**	$ 359,951

Net unamortized loan origination costs totaled $750,000 and $677,000 at December 31, 2012 and 2011, respectively and are included with their related loan class.

The Company has transferred a portion of its originated commercial, commercial real estate, agriculture and agriculture real estate loans to participating lenders. The amounts transferred have been accounted for as sales and are therefore not included in the Company's accompanying consolidated balance sheets. The Company and participating lenders share ratably in cash flows and any gains or losses that may result from a borrower's lack of compliance with contractual terms of the loan. The Company continues to service the loans on behalf of the participating lenders and, as such, collects cash payments from the borrowers, remits payments (net of servicing fees) to participating lenders and disburses required escrow funds to relevant parties. At December 31, 2012 and 2011, the Company was servicing loans for participants aggregating $7.8 million and $6.7 million, respectively.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments are due. Generally loans are placed on nonaccrual status if principal or interest payments become 90 days or more past due and/or management deems the collectability of the principal and/or interest to be in question, as well as when required by regulatory requirements.

Note 4 – Loans (Continued)

The following table presents past due loans by classes of the loan portfolio at December 31, 2012 and 2011:

(In thousands)	Current	30-89 Days Past Due	90 Days and Greater	Total Loans	Loans on Nonaccrual
December 31, 2012:					
Residential real estate:					
1-4 family	$ 125,502	$ 58	$ 206	$ 125,766	$ 206
Home equity	60,058	353	167	60,578	167
Commercial real estate	100,599	99	77	100,775	131
Agriculture real estate	24,405	-	-	24,405	48
Commercial loans	77,515	160	162	77,837	297
Agriculture loans	27,580	-	-	27,580	-
Consumer installment loans:					
Direct	14,528	36	-	14,564	-
Indirect	14,160	241	-	14,401	17
Total	$ 444,347	$ 947	$ 612	$ 445,906	$ 866

(In thousands)	Current	30-89 Days Past Due	90 Days and Greater	Total Loans	Loans on Nonaccrual
December 31, 2011:					
Residential real estate:					
1-4 family	$ 91,538	$ 231	$ 114	$ 91,883	$ 197
Home equity	51,392	408	-	51,800	-
Commercial real estate	83,817	376	-	84,193	4,956
Agriculture real estate	20,839	-	-	20,839	211
Commercial loans	58,600	178	-	58,778	371
Agriculture loans	23,018	6	-	23,024	6
Consumer installment loans:					
Direct	14,383	15	15	14,413	-
Indirect	14,981	40	-	15,021	200
Total	$ 358,568	$ 1,254	$ 129	$ 359,951	$ 5,941

At December 31, 2012 and 2011, loans that were over 90 days delinquent and still accruing interest totaled $0 and $15,000, respectively.

Note 4 – Loans (Continued)

Activity in the allowance for loan losses for the years ended December 31, 2012 and 2011 follows:

(In thousands)

December 31, 2012	Commercial	Commercial Real Estate	Agriculture	Agriculture Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Beginning balance	$ 1,210	$ 2,770	$ 259	$ 167	$ 1,362	$ 388	$ 845	$ 7,001
Provisions for loan losses	155	(122)	59	71	389	136	(238)	450
Recoveries of loans previously charged off	28	36	-	-	3	69	-	136
Loans charged off	(45)	(288)	-	-	(46)	(208)	-	(587)
Ending balance	$ 1,348	$ 2,396	$ 318	$ 238	$ 1,708	$ 385	$ 607	$ 7,000
December 31, 2011								
Beginning balance	$ 1,110	$ 2,040	$ 210	$ 152	$ 1,054	$ 517	$ 1,358	$ 6,441
Provisions for loan losses	346	720	49	15	400	(52)	(513)	965
Recoveries of loans previously charged off	62	10	-	-	19	138	-	229
Loans charged off	(308)	-	-	-	(111)	(215)	-	(634)
Ending balance	$ 1,210	$ 2,770	$ 259	$ 167	$ 1,362	$ 388	$ 845	$ 7,001

The allocation of the allowance for loan losses by loan class is as follows at December 31, 2012 and 2011:

(In thousands)

December 31, 2012	Commercial	Commercial Real Estate	Agriculture	Agriculture Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Amount of allowance for loan losses on loans individually evaluated for impairment	$ -	$ 1,088	$ -	$ -	$ -	$ -	$ -	$ 1,088
Amount of allowance for loan losses on loans collectively evaluated for impairment	1,348	1,308	318	238	1,708	385	607	5,912
Total allowance for loan losses	$ 1,348	$ 2,396	$ 318	$ 238	$ 1,708	$ 385	$ 607	$ 7,000
Loans individually evaluated for impairment	$ 297	$ 3,517	$ -	$ 48	$ -	$ -	$ -	$ 3,862
Loans collectively evaluated for impairment	77,540	97,258	27,580	24,357	186,344	28,965	-	442,044
Total Loans	$ 77,837	$ 100,775	$ 27,580	$ 24,405	$186,344	$ 28,965	$ -	$445,906

Note 4 – Loans (Continued)

December 31, 2011	Commercial	Commercial Real Estate	Agriculture	Agriculture Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Amount of allowance for loan losses on loans individually evaluated for impairment	$ 124	$ 1,687	$ -	$ -	$ -	$ -	$ -	$ 1,811
Amount of allowance for loan losses on loans collectively evaluated for impairment	1,086	1,083	259	167	1,362	388	845	5,190
Total allowance for loan losses	$ 1,210	$ 2,770	$ 259	$ 167	$ 1,362	$ 388	$ 845	$ 7,001
Loans individually evaluated for impairment	$ 371	$ 4,956	$ 6	$ 211	$ -	$ -	$ -	$ 5,544
Loans collectively evaluated for impairment	58,407	79,237	23,018	20,628	143,683	29,434	-	354,407
Total Loans	$ 58,778	$ 84,193	$ 23,024	$ 20,839	$143,683	$ 29,434	$ -	$359,951

Management is committed to early recognition of loan problems and to maintaining an adequate allowance. At least quarterly, management reviews all commercial and commercial real estate loans and leases and agriculturally related loans with an outstanding principal balance of over $100,000 that are internally risk rated substandard or worse, giving consideration to payment history, debt service payment capacity, collateral support, strength of guarantors, local market trends, industry trends, and other factors relevant to the particular borrowing relationship. Through this process, management identifies impaired loans. For loans considered impaired, estimated exposure amounts are based upon collateral values or present value of expected future cash flows discounted at the original effective interest rate of each loan. For commercial loans, commercial mortgage loans, agricultural mortgages and agricultural loans not specifically reviewed, and for homogenous loan portfolios such as residential mortgage loans and consumer loans, estimated exposure amounts are assigned based upon historical net loss experience and current charge-off trends, past due status, and management's judgment of the effects of current economic conditions on portfolio performance. In determining and assigning historical loss factors to the various homogeneous portfolios, the Company calculates average net losses over a period of time and compares this average to current levels and trends to ensure that the calculated average loss factor is reasonable.

Significant factors that could give rise to changes in these estimates may include, but are not limited to, changes in economic conditions in the local area, concentration of risk, changes in interest rates, and declines in local property values. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Note 4 – Loans (Continued)

The above allocation is neither indicative of the specific amounts or the loan categories in which future charge-offs may occur, nor is it an indicator of future loss trends. The allocation of the allowance to each category does not restrict the use of the allowance to absorb losses in any category.

The following table summarizes information regarding impaired loans by loan portfolio class as of December 31, 2012 and 2011:

(In thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2012					
With no related allowance recorded:					
Commercial loans	$ 297	$ 298	$ -	$ 275	$ 6
Commercial real estate	131	134	-	48	-
Agriculture loans	-	-	-	1	5
Agriculture real estate	48	99	-	91	103
With an allowance recorded:					
Commercial loans	-	-	-	94	-
Commercial real estate	3,386	3,783	1,088	4,494	-
Total	$ 3,862	$ 4,314	$ 1,088	$ 5,003	$ 114
Summary:					
Commercial	$ 3,814	$ 4,215	$ 1,088	$ 4,911	$ 6
Agriculture	48	99	-	92	108
Total	$ 3,862	$ 4,314	$ 1,088	$ 5,003	$ 114

(In thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2011					
With no related allowance recorded:					
Commercial loans	$ 247	$ 270	$ -	$ 72	$ 3
Commercial real estate	-	-	-	151	-
Agriculture loans	6	10	-	6	2
Agriculture real estate	211	377	-	231	-
With an allowance recorded:					
Commercial loans	124	124	124	245	-
Commercial real estate	4,956	5,327	1,687	4,887	-
Total	$ 5,544	$ 6,108	$ 1,811	$ 5,592	$ 5
Summary:					
Commercial	$ 5,327	$ 5,721	$ 1,811	$ 5,355	$ 3
Agriculture	217	387	-	237	2
Total	$ 5,544	$ 6,108	$ 1,811	$ 5,592	$ 5

Note 4 – Loans (Continued)

There were no troubled debt restructurings for the year ended December 31, 2012. The following is a summary of troubled debt restructurings for the year ended December 31, 2011:

(Dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
December 31, 2011			
Troubled debt restructurings:			
Commercial real estate	3	$ 4,070	$ 3,294

In 2011, two commercial real estate loans were granted an extension beyond normal circumstances to repay protective tax advances. The other commercial loan was granted a rate reduction.

Management performs a discounted cash flow calculation to determine the amount of impairment specific allocation required on each of the troubled debt restructurings. Any allocation required is recorded through the provision for loan losses.

There were no troubled debt restructurings that defaulted in the first twelve months after restructuring was granted.

Credit Quality

The Company utilizes a ten grade internal loan rating system for commercial, commercial real estate, agriculture and agriculture real estate loans. Loans that are rated "1" through "6" are considered "pass" rated loans with low to average risk.

Loans rated a "7" are considered "special mention". These loans have potential weaknesses that deserve management's close attention. These weaknesses may, if not checked or corrected, weaken the asset or inadequately protect the Company's position at some future date. Borrowers may be experiencing adverse operating trends, or an ill-proportioned balance sheet. Adverse economic or market conditions may also support a special mention rating. These assets pose elevated risks, but their weakness does not yet justify a substandard classification.

Loans rated an "8" are considered "substandard". Generally a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. Substandard loans have a high probability of payment default or they have other well-defined weaknesses. They require more intensive supervision by Company management. Substandard loans are generally characterized by current or unexpected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization.

Note 4 – Loans (Continued)

Credit Quality – continued

Loans rated a “9” are considered “doubtful”. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable. There were no doubtful loans at December 31, 2012 or 2011.

Loans rated a “10” are considered uncollectible (“loss”) and of such little value that their continuance as loans is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless loan even though partial recovery may be affected in the future. There were no loss loans at December 31, 2012 or 2011.

On an annual basis, or more often if needed, the Company formally reviews the ratings on all commercial, commercial real estate, agriculture and agriculture real estate loans. The Company also annually engages an independent third party to review a significant portion of loans within these classes. Management uses the results of these reviews as part of its annual review process.

The following table presents the classes of the commercial and agriculture loan portfolios summarized by the aggregate pass rating and the criticized and classified ratings of special mention and substandard within the Company's internal risk rating system as of December 31, 2012 and 2011:

(In thousands)

	Commercial	Commercial Real Estate	Agriculture	Agriculture Real Estate	Total
December 31, 2012					
Grade:					
Pass	$ 71,798	$ 93,688	$ 26,175	$ 22,029	$ 213,690
Special Mention	3,686	534	-	52	4,272
Substandard	2,353	6,553	1,405	2,324	12,635
Total	$ 77,837	$ 100,775	$ 27,580	$ 24,405	$ 230,597
December 31, 2011					
Grade:					
Pass	$ 51,970	$ 74,314	$ 21,732	$ 18,025	$ 166,041
Special Mention	5,245	1,259	19	62	6,585
Substandard	1,563	8,620	1,273	2,752	14,208
Total	$ 58,778	$ 84,193	$ 23,024	$ 20,839	$ 186,834

Note 4 – Loans (Continued)

Credit Quality – continued

Loans within the residential real estate and consumer portfolios do not have an internal loan rating system. Instead, they are monitored for past due status. If a residential real estate or consumer loan becomes 90 days past due, it is placed into nonaccrual status and the accrual of interest is discontinued.

Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual if collection of principal or interest is considered doubtful.

The following table presents the classes of the residential real estate and consumer loan portfolios summarized by performing or nonaccrual as of December 31, 2012 and 2011:

(In thousands)

	1-4 Family	Home Equity	Consumer - Direct	Consumer - Indirect	Total
December 31, 2012					
Performing	$ 125,560	$ 60,411	$ 14,564	$ 14,384	$ 214,919
Nonaccrual	206	167	-	17	390
Total	$ 125,766	$ 60,578	$ 14,564	$ 14,401	$ 215,309
December 31, 2011					
Performing	$ 91,686	$ 51,800	$ 14,413	$ 14,821	$ 172,720
Nonaccrual	197	-	-	200	397
Total	$ 91,883	$ 51,800	$ 14,413	$ 15,021	$ 173,117

Note 5 - Land, Premises and Equipment

Land, premises and equipment, net consist of the following at December 31, 2012 and 2011:

	2012	2011
	(In thousands)	
Land	**$ 2,956**	$ 2,956
Buildings	**12,595**	10,792
Furniture and equipment	**6,361**	5,482
Leasehold improvements	**438**	427
Construction in progress	**145**	1,332
	22,495	20,989
Less accumulated depreciation	**(7,093)**	(6,293)
	$ 15,402	$ 14,696

Note 5 - Land, Premises and Equipment (Continued)

Depreciation and amortization expense in 2012 and 2011 are included in noninterest expense as follows:

	2012	2011
	(In thousands)	
Buildings	**$ 313**	$ 277
Furniture and equipment	**556**	471
Leasehold improvements	**5**	8
	$ 874	$ 756

At December 31, 2012, the Bank leased three of its branch facilities, as well as two operations facilities under non-cancelable operating leases. Future minimum rental payments under these leases are as follows:

Years Ending December 31,	(In thousands)
2013	$ 162
2014	163
2015	89
2016	81
2017	82
Thereafter	150
	$ 727

Rent expense under the operating leases totaled $149,000 and $117,000 in 2012 and 2011, respectively.

At December 31, 2012, the Bank leased out space under non-cancelable operating leases. Future minimum rental payments to be received by the Company under these leases are as follows:

Years Ending December 31,	(In thousands)
2013	$ 130
2014	132
2015	118
2016	87
2017	74
Thereafter	314
	$ 855

Rent income under the operating leases totaled $124,000 and $82,000 in 2012 and 2011, respectively.

Note 6 - Deposits

Certificates of deposit in denominations of $100,000 and over were $63.8 million and $55.3 million at December 31, 2012 and 2011, respectively.

At December 31, 2012, scheduled maturities of time deposits are as follows:

Years Ending December 31,	(In thousands)
2013	$ 100,206
2014	21,301
2015	2,512
2016	2,619
2017	1,414
	$ 128,052

Note 7 - Securities Sold Under Agreements to Repurchase

Information concerning securities sold under agreements to repurchase as of and for the years ended December 31 is summarized as follows:

	2012	**2011**
	(In thousands)	
Average balance	**$ 7,982**	$7,416
Maximum month-end balance	**$11,409**	$8,832
Carrying amounts of securities, including accrued interest, underlying the agreements	**$ -**	$7,983

Securities sold under agreements to repurchase mature in less than 90 days from the transaction date. Securities sold under agreements to repurchase either remain under the control of the Bank or are held in third party custodial accounts that recognize the Bank's interest in the securities. During December 2012, the Company elected to discontinue offering this product and transferred those relationships to traditional deposit accounts.

Note 8 - Borrowings

Borrowings consist of overnight advances and fixed rate term borrowings. At December 31, 2012 and 2011, there were $5.0 million and $15.0 million in overnight advances outstanding, respectively. The table below details additional information related to overnight advances for the years ended December 31,

	2012	2011
	(Dollars in thousands)	
Average outstanding balance	**$ 1,086**	$ 6,190
Interest expense	**$ 3**	$ 23
Weighted average interest rate during the year	**0.32%**	0.37%
Weighted average interest rate at end of year	**0.31%**	0.31%

At December 31, 2012 there were no term advances outstanding. At December 31, 2011, there were term advances outstanding of $20.0 million, consisting of fixed rate, fixed term advances with a weighted average rate of 0.65% and a weighed average maturity of 4 months. During the year ended December 31, 2012, $20.0 million in term borrowings matured and were repaid.

As a member of the FHLB, the Bank can use certain unencumbered mortgage-related assets to secure borrowings from the FHLB. At December 31, 2012, total unencumbered mortgage-related loans were $70.6 million. Additional assets may also qualify as collateral for FHLB advances.

The Company, through the Bank, can use certain unencumbered collateral to secure borrowings at the Federal Reserve Bank. At December 31, 2012, total unencumbered collateral in the form of home equity loans and other consumer loans was $54.4 million.

The Company, through the Bank, had available unsecured line of credit agreements with correspondent banks permitting borrowings to a maximum of $10.0 million at December 31, 2012 and 2011. There were no outstanding advances against those lines at December 31, 2012 or 2011.

Note 9 - Junior Subordinated Debentures

On June 27, 2003, the Company issued $1.035 million in junior subordinated debentures due June 27, 2033, to Trust I. The Company owns all of the $35,000 in common equity of Trust I and the debentures are the sole asset of Trust I. Trust I issued $1.0 million of floating-rate trust capital securities in a non-public offering. The floating-rate capital securities provide for quarterly distributions at a variable annual coupon rate, reset quarterly, based on three-month LIBOR plus 2.75%. The coupon rate was 3.06% at December 31, 2012, and 3.33% at December 31, 2011. The securities are callable by the Company, subject to any required regulatory approval, at par, after June 2008.

The Company unconditionally guarantees the Trust I capital securities. The terms of the junior subordinated debentures and the common equity of Trust I mirror the terms of the trust capital securities issued by Trust I. The Company used the net proceeds from this offering to fund an additional $1.0 million capital investment in the Bank to fund its operations and future growth.

Note 9 - Junior Subordinated Debentures (Continued)

On August 23, 2004, the Company issued $5.155 million in junior subordinated debentures due August 23, 2034, to Trust II. The Company owns all of the $155,000 in common equity of Trust II and the debentures are the sole asset of Trust II. Trust II issued $5.0 million of floating-rate trust capital securities in a non-public offering. The floating-rate capital securities provide for quarterly distributions at a variable annual coupon rate, reset quarterly, based on three-month LIBOR plus 2.65%. The coupon rate was 2.9615% at December 31, 2012 and 3.145% at December 31, 2011. The securities are callable by the Company subject to any required regulatory approval, at par, after August 2009.

The Company unconditionally guarantees the Trust II capital securities. The terms of the junior subordinated debentures and the common equity of Trust II mirror the terms of the trust capital securities issued by Trust II. The Company used the net proceeds from this offering to fund an additional $5.0 million capital investment in the Bank to fund its operations and future growth.

In December 2009, the Company entered into an interest rate swap agreement (swap) with an effective date of February 23, 2011. The Company designated the swap as a cash flow hedge and it is intended to protect against the variability of cash flows associated with Trust II. The swap modifies the pricing characteristic of Trust II, wherein the Company receives interest at three-month LIBOR plus 2.65% from a counterparty and pays a fixed rate of interest of 6.80% to the same counterparty calculated on a notional amount of $5.0 million. This agreement will expire on November 23, 2019. The swap agreement was entered into with a counterparty that met the Company's credit standards, and the agreement contains collateral provisions protecting the at-risk party. The Company believes that the credit risk inherent in this contract is not significant. At December 31, 2012, the company pledged $1.2 million cash collateral to the counterparty.

At December 31, 2012 and 2011, the fair value of the swap agreement was a loss of $1.0 million and $933,000, respectively, and was the amount the Company would have expected to pay to terminate the agreement. The fair value of the swap is included in other liabilities in the accompanying consolidated balance sheets. The net effect of the swap increased interest expense by $188,000 and $166,000 in 2012 and 2011, respectively.

On February 12, 2010, the Company issued $3.027 million in junior subordinated debentures due February 12, 2040, to Trust III. The Company owns all of the $95,000 in common equity of Trust III and the debentures are the sole asset of Trust III. Trust III issued $2.932 million of fixed rate convertible trust capital securities in a non-public offering. These capital securities provide for quarterly distributions at a fixed annual coupon rate of 6.00%. The securities are callable by the Company, subject to any required regulatory approval, at par, after February 2015. Holders of the trust securities may convert the securities, at any time, into shares of the Company's common stock at a conversion price of $27.78 per share, subject to adjustments for splits, stock dividends, recapilization and the like and issuances on a pro rata basis below the current market value, in-kind dividends and tender offers above market value.

The Company unconditionally guarantees the Trust III capital securities. The terms of the junior subordinated debentures and the common equity of Trust III mirror the terms of the convertible trust capital securities issued by Trust III. The Company used the net proceeds from this offering to fund an additional $2.9 million capital investment in the Bank for its operations and future growth.

Note 9 - Junior Subordinated Debentures (Continued)

The accounts of Trust I, Trust II and Trust III are not included in the consolidated financial statements of the Company. However, for regulatory purposes, the trust capital securities qualify as Tier I capital of the Company subject to a 25% of capital limitation under risk-based capital guidelines. The portion that exceeds the 25% of capital limitation qualifies as Tier II capital. At December 31, 2012 and 2011, $9.0 million in trust capital securities qualified as Tier I capital.

Note 10 - Income Taxes

The provision for income taxes consists of the following for the years ended December 31:

	2012	2011
	(In thousands)	
Current tax provision:		
Federal	**$ 2,400**	$ 1,759
State	**2**	1
Total current tax provision	**2,402**	1,760
Deferred tax expense/(benefit):		
Federal	**11**	(71)
State	**(73)**	71
Total deferred tax expense/(benefit)	**(62)**	-
	$ 2,340	$ 1,760

Income tax expense differed from the statutory federal income tax rate for the years ended December 31 as follows:

	2012	2011
Statutory federal tax rate	**34.0%**	34.0%
Increase (decrease) resulting from:		
Tax-exempt interest income	**(6.5)**	(7.0)
Non-taxable earnings on bank-owned life insurance	**(0.9)**	(1.1)
Nondeductible expenses	**0.2**	0.1
Disallowed interest expense	**0.3**	0.4
Other, net	**0.4**	(0.9)
Effective tax rate	**27.5%**	25.5%

Note 10 - Income Taxes (Continued)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. Components of the Company's net deferred tax assets at December 31, included in other assets in the accompanying consolidated balance sheets, are as follows:

	2012	**2011**
	(In thousands)	
Deferred tax assets:		
Allowance for loan losses	**$ 2,592**	$ 2,559
Compensation and benefits	**3,194**	2,870
Other	**756**	458
Total deferred tax assets	**$ 6,542**	$ 5,887
Deferred tax liabilities:		
Prepaid pension	**$ 1,019**	$ 1,009
Depreciation	**569**	645
Net unrealized gains on available for sale securities	**1,697**	1,473
Other	**1,039**	557
Total deferred tax liabilities	**$ 4,324**	$ 3,684
Net deferred tax assets	**$ 2,218**	$ 2,203

Management believes it is more likely than not that all of the deferred tax assets will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

At December 31, 2012 and December 31, 2011, the Company had no unrecognized tax benefits. The Company does not expect the total amount of unrecognized tax benefits to significantly increase within the next twelve months.

The Company conducts business within New York State, as well as Pennsylvania through its partnership with New York State Title Agency West, LLC, and therefore files Federal, New York and Pennsylvania State tax returns. As the Company does not take uncertain tax positions, it has established no liability for uncertain tax positions. The Company did not have any accrued interest or penalties associated with any unrecognized tax benefits.

In the normal course of business the Company is subject to examination by taxing authorities. The Company is no longer subject to U.S. federal income tax examinations for years before 2010, or state income tax examinations for years before 2009.

Note 11 - Stockholders' Equity

The common stock and treasury stock of the Company at December 31, 2012 and 2011 are as follows:

	2012	2011
Common stock, authorized shares, \$0.50 par value	**2,000,000**	2,000,000
Issued shares [(1)]	**1,493,778**	1,301,496
Less: treasury stock shares[(1)]	**(7,264)**	(11,618)
Outstanding shares[(1)]	**1,486,514**	1,289,878

(1) Per share amounts have been adjusted to reflect a 3-for-2 stock split in the form of a stock dividend, effective February 29, 2012.

The components of accumulated other comprehensive loss, net of tax, as of December 31 were as follows:

	2012	2011
	(In thousands)	
Net actuarial losses and prior service costs for pension and postretirement benefit plans	**\$ (2,650)**	\$ (2,432)
Net unrealized gain on securities available for sale	**2,540**	2,209
Net unrealized gain on restricted equity securities	**6**	-
Net unrealized loss on the effective portion of cash flow hedge	**(607)**	(559)
Accumulated other comprehensive loss	**\$ (711)**	\$ (782)

The amounts of income tax expense (benefit) allocated to each component of other comprehensive income are as follows for the years ended December 31, 2012 and 2011:

	2012	2011
	(In thousands)	
Securities available for sale:		
Changes in net unrealized gains during the year	**\$ 306**	\$ 1,436
Reclassification adjustment for gains included in income	**(86)**	(163)
Changes in unrealized gains during the year of restricted equity securities	**4**	-
Pension and postretirement benefits:		
Amortization of prior service costs	**(1)**	-
Amortization of net loss	**100**	42
Net actuarial loss	**(245)**	(870)
Change in net unrealized losses on the effective portion of cash flow hedge	**(31)**	(220)
Tax expense	**\$ 47**	\$ 225

Note 11 - Stockholders' Equity (Continued)

The balances and changes in the components of accumulated other comprehensive loss are as follows:

(In thousands)	Unrealized gains on securities available for sale	Unrealized gains on restricted equity securities	Pension and postretirement benefits	Unrealized losses on cash flow hedge	Accumulated other comprehensive loss
Balance – January 1, 2011	$ 299	$ -	$ (1,190)	$ (230)	$ (1,121)
Other comprehensive income (loss) for 2011	1,910	-	(1,242)	(329)	339
Balance – December 31, 2011	2,209	-	(2,432)	(559)	(782)
Other comprehensive income (loss) for 2012	331	6	(218)	(48)	71
Balance – December 31, 2012	$ 2,540	$ 6	$ (2,650)	$ (607)	$ (711)

On June 27, 2012, the Company completed a common stock offering of 192,307 shares, at $26.00 per share, for new capital proceeds (net of expenses) of $4.4 million.

Note 12 - Pension and Postretirement Benefit Plans

The Company participates in the New York State Bankers Retirement System (the "System"), a non-contributory defined benefit pension plan (the "Pension Plan") covering substantially all employees. The benefits are based on years of service and the employee's highest average compensation during five consecutive years of employment.

The Company also maintains an unfunded postretirement health insurance plan (the "Healthcare Plan") for certain employees meeting eligibility requirements.

The Company engages independent, external actuaries to compute the amounts of liabilities and expense relating to these plans, subject to the assumptions that the Company selects. The benefit obligation for these plans represents the liability of the Company for current and retired employees, and is affected primarily by the following: service cost (benefits attributed to employee service during the period); interest cost (interest on the liability due to the passage of time); actuarial gains/losses (experience during the year different from that assumed and changes in plan assumptions); and benefits paid to participants.

Note 12 - Pension and Postretirement Benefit Plans (Continued)

The following table provides a reconciliation of the changes in the Pension Plan's benefit obligations and fair value of assets and the accumulated benefit obligation for the Healthcare Plan for the years ending December 31, 2012 and 2011:

	Pension Plan		Healthcare Plan	
	2012	**2011**	**2012**	**2011**
	(In thousands)			
Change in benefit obligation:				
Benefit obligation at beginning of year	**$ 7,965**	$ 5,574	**$ 424**	$ 388
Service cost	**848**	599	**3**	4
Interest cost	**333**	296	**21**	24
Actuarial loss	**813**	1,719	**47**	38
Expenses	**(11)**	(7)	**-**	-
Benefits paid	**(309)**	(216)	**(32)**	(30)
Benefit obligation at end of year	**9,639**	7,965	**463**	424
Change in plan assets:				
Fair value of plan assets at beginning of year	**6,600**	6,065	**-**	-
Actual return on plan assets	**687**	1	**-**	-
Employer contribution	**1,000**	750	**32**	30
Benefits paid	**(309)**	(216)	**(32)**	(30)
Fair value of plan assets at end of year	**7,978**	6,600	**-**	-
Funded status recognized	**$(1,661)**	$(1,365)	**$ (463)**	$ (424)
Accumulated benefit obligation	**$ 7,722**	$ 6,380	**$ 463**	$ 424

The underfunded status of the Pension Plan and the unfunded status of the Healthcare Plan has been recognized in other liabilities in the consolidated balance sheets at December 31, 2012 and 2011.

Note 12 - Pension and Postretirement Benefit Plans (Continued)

The components of net periodic benefit cost and other comprehensive income are as follows:

	Pension Plan		Healthcare Plan	
	2012	**2011**	**2012**	**2011**
		(In thousands)		
Components of net periodic benefit cost:				
Service cost	**$ 848**	$ 599	**$ 3**	$ 4
Interest cost	**333**	296	**21**	24
Expected return on plan assets	**(451)**	(417)	**-**	-
Amortization of prior service cost (credit)	**1**	1	**(4)**	-
Amortization of net loss	**243**	100	**8**	4
Net periodic benefit cost	**$ 974**	$ 579	**$ 28**	$ 32
Other changes in plan assets and benefit obligations recognized in other comprehensive income:				
Net loss	**$ 565**	$ 2,137	**$ 47**	$ 38
Recognized actuarial loss	**(243)**	(100)	**(8)**	(4)
Recognized prior service (cost) credit	**(1)**	(1)	**4**	-
Recognized in other comprehensive income	**$ 321**	$ 2,036	**$ 43**	$ 34
Total recognized in net periodic benefit cost and other comprehensive income	**$ 1,295**	$ 2,615	**$ 71**	$ 66

The following table presents the components of accumulated other comprehensive loss, net of taxes, as of December 31:

	Pension Plan		Healthcare Plan	
	2012	**2011**	**2012**	**2011**
		(In thousands)		
Prior service cost (credit)	**$ 3**	$ 3	**$ (20)**	$ (22)
Net actuarial loss	**2,574**	2,381	**93**	70
	$ 2,577	$ 2,384	**$ 73**	$ 48

The estimated costs that will be amortized from accumulated other comprehensive loss into net periodic cost during 2013 are as follows:

	Pension Plan	Healthcare Plan	Total
		(In thousands)	
Prior service cost (credit)	**$ 1**	**$ (4)**	**$ (3)**
Net actuarial loss	**257**	**10**	**267**
Total	**$ 258**	**$ 6**	**$ 264**

Note 12 - Pension and Postretirement Benefit Plans (Continued)

Weighted-average assumptions used in accounting for the plans were as follows:

	Pension Plan		Healthcare Plan	
	2012	2011	2012	2011
Discount rates:				
Benefit cost for Plan Year	**4.27%**	5.38%	**4.50%**	5.50%
Benefit obligation at end of Plan Year	**3.84%**	4.27%	**3.84%**	4.50%
Expected long-term return on plan assets	**7.00%**	7.00%	**N/A**	N/A
Rate of compensation increase:				
Benefit cost for Plan Year	**3.00%**	3.00%	**N/A**	N/A
Benefit obligation at end of Plan Year	**3.00%**	3.00%	**N/A**	N/A

The assumed health care cost trend rate used in the postretirement benefit plan at December 31, 2012 was 4.00%. Assumed health care trend rates may have a significant effect on the amounts reported for this plan. A 1% increase in the trend rate would increase the periodic benefit cost by $3,000 and increase the accumulated postretirement benefit obligation by $64,000.

The discount rate used for each period was based upon the rates of return on high-quality fixed income investments. The objective of using this approach is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay benefits when they became due. The discount rates are evaluated at each measurement date to give effect to changes in the general level of interest rates.

The Company's funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of the Internal Revenue Code. While the Company has satisfied the minimum funding requirement for 2012, it expects to contribute to the Pension Plan during 2013. However, the amount of the contribution is not known at this time.

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows:

	Pension Plan	Healthcare Plan
Years Ending December 31,	(In thousands)	
2013	**$ 183**	**$ 34**
2014	**215**	**34**
2015	**276**	**34**
2016	**308**	**33**
2017	**338**	**33**
2018 - 2022	**2,172**	**160**
	$ 3,492	**$ 328**

Note 12 - Pension and Postretirement Benefit Plans (Continued)

The fair value of the Company's pension plan assets at December 31, 2012 and 2011 by asset category are as follows:

	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
		(In thousands)		
December 31, 2012:				
Cash equivalents:				
Foreign currencies	$ 8	$ 8	$ -	$ -
Government issues	43	-	43	-
Short term investment funds	978	-	978	-
Total cash equivalents	1,029	8	1,021	-
Equity securities:				
Common stock	3,513	3,513	-	-
Depository receipts	79	79	-	-
Preferred stock	16	16	-	-
Real estate investment trust	16	16	-	-
Total equity securities	3,624	3,624	-	-
Fixed income securities:				
Auto loan receivable	43	-	43	-
Collateralized mortgage obligations	865	-	865	-
Corporate bonds	753	-	753	-
Federal Home Loan Mortgage Corporation	99	-	99	-
Federal National Mortgage Association	396	-	396	-
Government National Mortgage Association I	4	-	4	-
Government National Mortgage Association II	18	-	18	-
Government issues	1,136	-	1,136	-
Municipals	9	-	9	-
Other asset backed securities	2	-	2	-
Total fixed income securities	3,325	-	3,325	-
Total	$ 7,978	$ 3,632	$ 4,346	$ -

Note 12 - Pension and Postretirement Benefit Plans (Continued)

	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
		(In thousands)		
December 31, 2011:				
Cash equivalents:				
Foreign currencies	$ 12	$ 12	$ -	$ -
Short term investment funds	689	-	689	-
Total cash equivalents	701	12	689	-
Equity securities:				
Common stock	3,086	3,086	-	-
Depository receipts	66	66	-	-
Preferred stock	10	10	-	-
Total equity securities	3,162	3,162	-	-
Fixed income securities:				
Auto loan receivable	1	-	1	-
Collateralized mortgage obligations	645	-	645	-
Corporate bonds	586	-	586	-
Federal Home Loan Mortgage Corporation	114	-	114	-
Federal National Mortgage Association	351	-	351	-
Government National Mortgage Association I	5	-	5	-
Government National Mortgage Association II	25	-	25	-
Government issues	995	-	995	-
Municipals	8	-	8	-
Other asset backed securities	7	-	7	-
Total fixed income securities	2,737	-	2,737	-
Total	$ 6,600	$ 3,174	$ 3,426	$ -

At December 31, 2012 and 2011, the portfolio was managed by two investment firms. In addition, as of December 31, 2012, approximately $624,000 of Pension Plan monies had not yet been allocated to either investment manager. Control was split at approximately 49%, 43% and 8%. At December 31, 2011, the portfolio was split with approximately 46% and 52% under the control of the investment managers, with the remaining 2% under the direct control of the Pension Plan.

At December 31, 2012 and 2011, there was a 12% and 10% portfolio concentration in the State Street & Trust Co. Short Term Investment Fund, respectively.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an 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.

Note 12 - Pension and Postretirement Benefit Plans (Continued)

Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

- Level 1—Quoted prices in active markets for identical assets or liabilities.

- Level 2—Inputs other than Level 1 that are observable, either directly or indirectly, 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 for substantially the full term of the assets or liabilities.

- Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Investments valued using the Net Asset Value (NAV) are classified as Level 2 if the Pension Plan can redeem its investment with the investee at the NAV at the measurement date. If the Pension Plan can never redeem the investment with the investee at the NAV, it is considered a Level 3. If the Pension Plan can redeem the investment at the NAV at a future date, the Pension Plan's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.

The Pension Plan uses the Thomsson Reuters Pricing Service to determine the fair value of equities and the pricing service of IDC Corporate USA to determine the fair value of fixed income securities.

There were no transfers in or out of Level 3 in the years ended December 31, 2012 and 2011.

The Pension Plan was established in 1938 to provide for the payment of benefits to employees of participating banks. The Pension Plan is overseen by a Board of Trustees who meet quarterly and set the investment policy guidelines.

The overall investment strategy is to achieve a mix of approximately 97% of investments for long-term growth and 3% for near-term benefit payments with a wide diversification of asset types, fund strategies, and fund managers. The target allocations are shown in the table below. Cash equivalents consist primarily of short term investment funds. Equity securities primarily include investments in common stock. Fixed income securities primarily include corporate bonds, collateralized mortgage obligations, government issued and mortgage backed securities.

Note 12 - Pension and Postretirement Benefit Plans (Continued)

The weighted average expected long-term rate of return is estimated based on current trends as well as projected future rates of return on those assets and reasonable actuarial assumptions based on the guidance provided by Actuarial Standard Of Practice No. 27 "Selection of Economic Assumptions for Measuring Pension Obligations" for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The following assumptions were used in determining the long-term rate of return:

Equity securities: Dividend discount model, the smoothed earnings yield model, and the equity risk premium model

Fixed income securities: Current yield-to-maturity and forecasts of future yields

The long term rate of return considers historical returns. Adjustments were made to historical returns in order to reflect expectations of future returns. These adjustments were due to factor forecasts by economists and long-term U.S. Treasury yields to forecast long-term inflation. In addition, forecasts by economists and others for long-term gross domestic product growth were factored into the development of assumptions for earnings growth and per capita income.

Effective September 2011, the investment guidelines were revised. Currently, investment managers are prohibited from purchasing the following investments:

Equity securities:

- Short sales,
- Unregistered securities, and
- Margin purchases.

Fixed income securities:

- Mortgage backed derivatives that have an inverse floating rate coupon or that are interest only securities,
- Any asset backed security that is not issued by the U.S. government or its agencies or instrumentalities,
- In general, securities of less than Baa2/BBB quality, and
- Securities of less than A-quality may not in the aggregate exceed 10% of the investment manager's portfolio

Other financial instruments:

- Unhedged currency exposure in countries not defined as "high income economies" by the World Bank.

Note 12 - Pension and Postretirement Benefit Plans (Continued)

Prior to September 2011, investments in emerging countries as defined by the Morgan Stanley Emerging Markets Index and structured notes were prohibited.

All other investments not prohibited by policy are permitted. At December 31, 2012 and 2011 the Pension Plan holds certain investments which are no longer deemed acceptable to acquire. These positions will be liquidated when the investment managers deem that such liquidation is in the best interest of the Pension Plan.

The target allocation for 2013 and actual allocation of plan assets as of December 31, 2012 and 2011 are as follows:

Asset Category	Target Allocation 2013	% of Plan Assets at December 31, 2012	2011
Cash equivalents	0-20%	12.8%	10.6%
Equity securities	40-60%	45.5%	47.9%
Fixed income securities	40-60%	41.7%	41.5%
Other financial instruments	0-5%	-	-

Defined Contribution Plan

The Bank has a contributory 401(k) Plan for substantially all employees. Employees are eligible to contribute a percentage of their salary up to the maximum as determined by the Internal Revenue Service. The Bank is required to match 75% of the employees' contributions up to a maximum of 6% of the employees' salaries. The Bank contributed $246,000 and $230,000 under these provisions during 2012 and 2011, respectively.

Supplemental Employee Retirement Plans

The Company maintains supplemental employee retirement plans (the “SERP”) for certain executives. All benefits provided under the SERP are unfunded and, as these executives retire, the Company will make payments to plan participants. The unfunded status of the SERP at December 31, 2012 and 2011 was $2.5 million and $2.2 million, respectively, and is recorded in other liabilities in the consolidated balance sheets. Compensation expense related to the SERP was $360,000 for both of the years ended December 31, 2012 and 2011.

Deferred Compensation Plans

Prior to 2007, the Company had entered into employment agreements with key executives. These employment agreements established deferred compensation plans whereby Company stock was awarded and vested each year. In 2007, the Company terminated the employment agreements and related deferred compensation plans and established new deferred compensation plans for key executives. The new plans require a vesting period of three years from the original date the executive entered the plan. Awarded shares from both the prior plan and the current plan are restricted from being sold until employment is terminated.

Note 12 - Pension and Postretirement Benefit Plans (Continued)

Deferred Compensation Plans - continued

The Company obtains shares for the new deferred compensation plan either through open market purchases or from treasury shares. The amount of awarded shares is based on the amount earned by each executive under the deferred compensation plan. The executives are awarded a number of shares based on the amount of deferred compensation earned divided by the value of the shares. The value of the shares purchased on the open market is the price paid. The value of the shares from treasury is the average daily closing price of the stock for each day within the past quarter. Total deferred compensation shares were 55,242 and 50,068 at December 31, 2012 and 2011, respectively. Total shares awarded were 5,175 and 4,839 for 2012 and 2011, respectively, while total nonvested shares were 43 at December 31, 2011. There were no unvested shares at December 31, 2012. Compensation expense is recognized over the vesting period, and is based upon the total amount of the value of the shares awarded to each executive. Compensation expense related to the plan was approximately $108,000 and $103,000 for the years ended December 31, 2012 and 2011, respectively.

Note 13 - Earnings Per Share

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for each of the years ended December 31:

	2012	2011
	(in thousands, except per share data)	
Net income available to common shareholders	**$ 6,170**	$ 5,138
Adjustment for dilutive potential common shares	**107**	107
Net income available for diluted common shares	**$ 6,277**	$ 5,245
Weighted average common shares used to calculate basic EPS	**1,391,330**	1,289,790
Add: effect of common stock equivalents	**105,552**	105,552
Weighted average common shares used to calculate diluted EPS	**1,496,882**	1,395,342
Earnings per common share:		
Basic	**$ 4.43**	$ 3.98
Diluted	**$ 4.19**	$ 3.76

Note 14 - Related Party Transactions

In the ordinary course of business, the Bank has and expects to continue to have transactions, including loans and deposit accounts, with the Company's and the Bank's executive officers and directors and their affiliates. In the opinion of management, such transactions were on substantially the same terms, including interest rates and collateral, as those prevailing at the time of comparable transactions with other unrelated persons and did not involve more than a normal risk of collectability or present any other unfavorable features.

Note 14 - Related Party Transactions (Continued)

The rollforward of loans to related parties for the years ended December 31 is as follows:

	2012	2011
	(In thousands)	
Beginning balance, January 1	**$ 5,778**	$ 9,211
New loans	**840**	894
Repayments	**(869)**	(929)
	5,749	9,176
Less loans to directors who retired during the year	**-**	(3,398)
Ending balance, December 31	**$ 5,749**	$ 5,778

The Bank has an operating lease with one of its directors. Under the terms of the lease, the Bank receives monthly payments of approximately $3,940 through August 2013, increasing 2.5% per year thereafter until August 2015.

Note 15 - Commitments and Contingent Liabilities

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments summarized as follows at December 31:

	2012	**2011**
	(In thousands)	
Commitments to extend credit:		
Commitments to grant loans	**$ 63,296**	$ 45,191
Unfunded commitments under commercial lines of credit	**49,495**	38,006
Unfunded commitments under consumer lines of credit	**39,238**	34,078
Standby letters of credit	**8,938**	8,061
	$ 160,967	$ 125,336

Note 15 - Commitments and Contingent Liabilities (Continued)

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount and type of collateral obtained, if deemed necessary by the Bank upon extension of credit, varies and is based on management's credit evaluation of the counterparty.

Standby letters of credit are conditional lending commitments issued by the Bank to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. Generally, letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit. The Bank generally holds collateral supporting those commitments. Such collateral amounted to $7.3 million and $7.8 million at December 31, 2012 and 2011, respectively. The amount of the liability related to guarantees under standby letters of credit was not material at December 31, 2012 and 2011.

In addition to other investors, the Bank sells residential mortgage loans to the FHLB. The agreement with the FHLB includes a maximum credit enhancement liability of $3.8 million and $3.3 million at December 31, 2012 and 2011 respectively, which the Bank may be required to pay if realized losses on any of the sold mortgages exceed the amount held in the FHLB's spread account. The FHLB is funding the spread account annually based on the outstanding balance of loans sold. The Bank's historical losses on residential mortgages have been lower than the amount being funded to the spread account. As such, the Bank does not anticipate recognizing any losses and, accordingly, has not recorded a liability for the credit enhancement.

Note 16 - Concentrations of Credit

The Company's loan customers are located primarily in the New York communities served by the Bank. Investments in state and local government securities also involve governmental entities within the Company's market area. Although operating in numerous communities in New York State, the Company is still dependant on the general economic conditions of New York. The largest concentration of credit by industry is Dairy Cattle and Milk Production, with loans outstanding of $17.8 million or 3.98% of total loans as of December 31, 2012. Risk related to this concentration is controlled through adherence to Farm Services Agency (FSA) standards for guaranteed loans, such as diligence in farm visits and loan closings per conditional commitments issued by FSA. The Company, as a matter of policy, does not extend credit to any single borrower, or group of related borrowers, in excess of its legal lending limit. Further information on the Company's lending activities is provided in "Note 4 Loans" in Notes to Consolidated Financial Statements.

Note 17 - Regulatory Matters

The supervision and regulation of financial and bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds regulated by the Federal Deposit Insurance Corporation ("FDIC") and the banking system as a whole, and not for the protection of shareholders or creditors of bank holding companies. The various bank regulatory agencies have broad enforcement power over financial holding companies and banks, including the power to impose substantial fines, operational restrictions and other penalties for violations of laws and regulations and for safety and soundness considerations.

Capital

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined by regulation) and of Tier I capital (as defined) to average assets (as defined).

Management believes, as of December 31, 2012, that the Company and the Bank meet all capital adequacy requirements to which it is subject.

As of the most recent notification from the Office of the Comptroller of the Currency, the Bank was categorized as well capitalized. There are no conditions or events since the notification that management believes have changed the institution's category.

The Company's and the Bank's capital amounts and ratios are also presented in the table below.

Note 17 - Regulatory Matters (Continued)

Capital - continued

(Dollars in thousands)

	Actual		For Capital Adequacy Purposes		To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2012:						
Total risk-based capital						
Consolidated	**$60,169**	**13.2 %**	**$≥36,409**	**≥8.0 %**	**$≥45,511**	**≥10.0 %**
Bank	**$60,149**	**13.2 %**	**$≥36,440**	**≥8.0 %**	**$≥45,550**	**≥10.0 %**
Tier 1 capital						
Consolidated	**$54,476**	**12.0 %**	**$≥18,205**	**≥4.0 %**	**$≥27,307**	**≥6.0 %**
Bank	**$54,456**	**12.0 %**	**$≥18,220**	**≥4.0 %**	**$≥27,330**	**≥6.0 %**
Tier 1 leverage						
Consolidated	**$54,476**	**8.3 %**	**$≥26,391**	**≥4.0 %**	**$≥32,989**	**≥ 5.0 %**
Bank	**$54,456**	**8.3 %**	**$≥26,367**	**≥4.0 %**	**$≥32,959**	**≥ 5.0 %**
December 31, 2011:						
Total risk-based capital						
Consolidated	$50,110	13.8 %	$≥29,103	≥8.0 %	$≥36,379	≥10.0 %
Bank	$50,364	13.8 %	$≥29,107	≥8.0 %	$≥36,384	≥10.0 %
Tier 1 capital						
Consolidated	$45,562	12.5 %	$≥14,551	≥4.0 %	$≥21,827	≥ 6.0 %
Bank	$45,816	12.6 %	$≥14,554	≥4.0 %	$≥21,830	≥ 6.0 %
Tier 1 leverage						
Consolidated	$45,562	8.4 %	$≥21,794	≥4.0 %	$≥27,242	≥ 5.0 %
Bank	$45,816	8.4 %	$≥21,765	≥4.0 %	$≥27,206	≥ 5.0 %

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from the Bank to provide funds for the payment of interest expense on the junior subordinated debentures, dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years.

At December 31, 2012, the Bank's retained earnings available for the payment of dividends was approximately $13.8 million.

Note 18 - Fair Value Measurements and Fair Values of Financial Instruments

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various assets and liabilities. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

Fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment.

Fair Value Hierarchy

The Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1: Valuation is based on unadjusted quoted prices in active markets for identical assets or liabilities that are accessible at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market.

Level 2: Valuation is based upon inputs other than quoted prices included within level 1 that are observable either directly or indirectly. The valuation may be based on 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 for substantially the full term of the asset or liability.

Level 3: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value measurement. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Note 18 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at December 31, 2012 and 2011:

Cash, Due From Banks, and Interest-bearing Deposits in Banks

The carrying amounts reported in the consolidated balance sheets for these assets approximate fair values based on the short-term nature of the assets.

Investment Securities

The fair value of securities available for sale and held to maturity are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or pricing models (Level 2), which consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of external support on certain Level 3 investments. Management has determined that the fair value of local government securities in the held to maturity portfolio approximate their carrying value. Restricted equity securities have restrictions on their sale and are primarily carried at cost due to their limited marketability. The fair value of the Company's investment in Farmer Mac is determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1).

Loans Held for Sale

The fair value of loans held for sale is determined using quoted secondary-market prices. If no such quoted prices exist, the fair value of a loan is determined using quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan, resulting in a Level 2 classification.

Loans

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans, resulting in a Level 3 classification. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal.

Note 18 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Impaired Loans

The fair value of loans considered impaired is generally determined based upon independent third party appraisals of the properties (market approach), or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances of $3.4 million and $5.1 million, net of valuation allowances of $1.1 million and $1.8 million as of December 31, 2012 and 2011, respectively.

Accrued Interest Receivable and Payable

The carrying amount of accrued interest receivable and accrued interest payable approximates fair value.

Mortgage Servicing Rights

The carrying amount of mortgage servicing rights approximates their fair value.

Deposits

The fair values disclosed for demand and savings deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits, resulting in a Level 2 classification.

Securities Sold Under Agreements to Repurchase

The carrying amounts of securities sold under agreements to repurchase approximate their fair values.

Borrowings from the Federal Home Loan Bank

Fair values of borrowings from the FHLB are estimated using discounted cash flow analysis, based on quoted prices for new borrowings from the FHLB with similar credit risk characteristics, terms and remaining maturity, resulting in a Level 2 classification. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

Junior Subordinated Debentures

The fair values of junior subordinated debentures are estimated using discounted cash flow analysis, based on market rates currently offered on such debt with similar credit risk characteristics, terms and remaining maturity, resulting in a Level 2 classification.

Note 18 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Interest Rate Swap Agreements

The fair value of the interest rate swap derivative is calculated based on a discounted cash flow model. All future floating cash flows are projected and both floating and fixed cash flows are discounted to the valuation date. The curve utilized for discounting and projecting is built by obtaining publicly available third party market quotes for various swap maturity terms, resulting in a Level 2 classification.

Off-Balance Sheet Financial Instruments

Fair values for off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

	Carrying Value	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
		(In thousands)		
December 31, 2012:				
Securities available for sale:				
United States treasuries	**$ 10,127**	**$ -**	**$ 10,127**	**$ -**
United States agencies	**46,768**	**-**	**46,768**	**-**
State and local governments	**61,213**	**-**	**61,213**	**-**
Mortgage-backed securities	**44,188**	**-**	**44,188**	**-**
Total securities available for sale	**$ 162,296**	**$ -**	**$ 162,296**	**$ -**
Restricted equity security	**$ 51**	**$ 51**	**$ -**	**$ -**
Interest rate swap agreements	**$ (1,011)**	**$ -**	**$ (1,011)**	**$ -**
December 31, 2011:				
Securities available for sale:				
United States treasuries	$ 5,155	$ -	$ 5,155	$ -
United States agencies	30,812	-	30,812	-
State and local governments	51,409	-	51,409	-
Mortgage-backed securities	55,704	-	55,704	-
Total securities available for sale	$ 143,080	$ -	$ 143,080	$ -
Interest rate swap agreements	$ (933)	$ -	$ (933)	$ -

Note 18 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Assets Measured at Fair Value on a Nonrecurring Basis

There were no assets measured at fair value on a nonrecurring basis at December 31, 2012.

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

	Carrying Value	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
	(In thousands)			
December 31, 2011:				
Impaired loans	$ 3,269	$ -	$ -	$ 3,269

There were no impairment charges on loans related to the above nonrecurring fair value measurements, included in the provision for loans losses, for the year ended December 31, 2011.

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2012 and 2011 are as follows:

		2012		2011	
	Fair Value Hierarchy	**Carrying Amount**	**Fair Value**	Carrying Amount	Fair Value
		(In thousands)			
Financial assets:					
Cash and due from banks	1	**$ 13,421**	**$ 13,421**	$ 13,749	$ 13,749
Interest-bearing deposits in banks	1	**7,661**	**7,661**	5,326	5,326
Investment securities	2	**174,813**	**174,813**	154,639	154,639
Loans, net of allowance	3	**438,906**	**450,745**	352,950	360,807
Accrued interest receivable	1	**2,342**	**2,342**	2,073	2,073
Mortgage servicing rights	1	**505**	**505**	462	462
Financial liabilities:					
Demand and savings deposits	1	**$ 470,253**	**$ 470,069**	$ 345,944	$ 345,826
Certificates of deposit	2	**128,052**	**128,856**	115,055	115,708
Securities sold under agreements to repurchase	1	**-**	**-**	7,058	7,058
Borrowings from FHLB	2	**5,000**	**5,000**	35,000	35,036
Junior subordinated debentures	2	**9,217**	**9,508**	9,217	8,263
Interest rate swap agreements	2	**1,011**	**1,011**	933	933
Accrued interest payable	1	**85**	**85**	93	93

Note 18 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Amounts in the preceding table are included in the consolidated balance sheets under the applicable captions. The fair values of off-balance sheet financial instruments are not significant.

Note 19 – Subsequent Events

The Company has evaluated events through March 8, 2013 the date these consolidated financial statements were available to be issued.

Lyons Bancorp, Inc.
It's all about people.

PROFILE

Lyons Bancorp, Inc. is a bank holding company headquartered in Lyons, New York, with assets of $665 million at December 31, 2012. Lyons Bancorp, Inc. has one banking subsidiary, The Lyons National Bank.

The Lyons National Bank is a community bank with offices in Clyde, Lyons, Macedon, Newark, Ontario and Wolcott in Wayne County, Jordan in Onondaga County, Canandaigua and Geneva in Ontario County, Penn Yan in Yates County and Waterloo in Seneca County. The Lyons National Bank has one subsidiary, Lyons Realty Associates Corp.

STOCK SYMBOL

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