

CHEMUNG FINANCIAL CORP
Form 10-Q
November 17, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

FORM 10-Q
 QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For Quarterly period ended September 30, 2014

Or

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

Commission File No. 0-13888

CHEMUNG FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

New York 16-1237038
(State or other jurisdiction of incorporation or organization) I.R.S. Employer Identification No.

One Chemung Canal Plaza, P.O. Box 1522, Elmira, NY 14902
(Address of principal executive offices) (Zip Code)

(607) 737-3711 or (800) 836-3711
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES: NO:

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES: NO:

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

YES: NO:

The number of shares of the registrant's common stock, \$.01 par value, outstanding on November 14, 2014 was 4,618,839.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIESINDEX

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GLOSSARY OF TERMS AND ABBREVIATIONS

To assist the reader the Corporation has provided the following list of commonly used acronyms and abbreviations included in the Notes to Unaudited Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations.

| | |
|-------------|--|
| ASU | Accounting Standards Update |
| BANK | Chemung Canal Trust Company |
| CDO | Collateralized Debt Obligation |
| CORPORATION | Chemung Financial Corporation |
| FASB | Financial Accounting Standards Board |
| FDIC | Federal Deposit Insurance Corporation |
| FHLBNY | Federal Home Loan Bank New York |
| FRB | Board of Governors of the Federal Reserve System |
| FRBNY | Federal Reserve Bank of New York |
| FREDDIE MAC | Federal Home Loan Mortgage Corporation |
| GAAP | United States Generally Accepted Accounting Principles |
| OTTI | Other-Than-Temporary Impairment |
| PCI | Purchased Credit Impaired |
| SEC | Securities and Exchange Commission |
| TDR | Troubled Debt Restructuring |

PART I. FINANCIAL INFORMATION

Item 1: Financial Statements-Unaudited

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

UNAUDITED

| | September 30, 2014 | December 31, 2013 |
|--|-----------------------|----------------------|
| (dollars in thousands, except per share data) | | |
| ASSETS | | |
| Cash and due from financial institutions | \$31,957 | \$31,600 |
| Interest-bearing deposits in other financial institutions | 3,069 | 20,009 |
| Total cash and cash equivalents | 35,026 | 51,609 |
| Trading assets, at fair value | 483 | 366 |
| Securities available for sale, at estimated fair value | 288,097 | 346,016 |
| Securities held to maturity, estimated fair value of \$5,821 at September 30, 2014 and \$6,930 at December 31, 2013 | 5,430 | 6,495 |
| Federal Home Loan Bank and Federal Reserve Bank Stock, at cost | 4,362 | 4,482 |
| Loans, net of deferred origination fees and costs, and unearned income | 1,114,182 | 995,866 |
| Allowance for loan losses | (13,151) | (12,776) |
| Loans, net | 1,101,031 | 983,090 |
| Loans held for sale | 1,167 | 695 |
| Premises and equipment, net | 32,431 | 30,039 |
| Goodwill | 21,824 | 21,824 |
| Other intangible assets, net | 5,384 | 6,377 |
| Bank owned life insurance | 2,744 | 2,796 |
| Accrued interest and other assets | 25,578 | 22,354 |
| Total assets | \$ 1,523,557 | \$ 1,476,143 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Non-interest-bearing | \$372,916 | \$351,222 |
| Interest-bearing | 938,083 | 915,034 |
| Total deposits | 1,310,999 | 1,266,256 |
| Securities sold under agreements to repurchase | 30,981 | 32,701 |
| Federal Home Loan Bank term advances | 24,086 | 25,243 |
| Long term capital lease obligations | 3,039 | - |
| Dividends payable | 1,201 | 1,195 |
| Accrued interest payable and other liabilities | 13,690 | 12,170 |
| Total liabilities | 1,383,996 | 1,337,565 |
| Shareholders' equity: | | |
| Common stock, \$.01 par value per share, 10,000,000 shares authorized; 5,310,076 issued at September 30, 2014 and December 31, 2013 | 53 | 53 |
| Additional-paid-in-capital | 45,555 | 45,399 |
| Retained earnings | 111,105 | 111,031 |
| Treasury stock, at cost (691,237 shares at September 30, 2014; 707,674 shares at December 31, 2013) | (17,640) | (18,060) |
| Accumulated other comprehensive income | 488 | 155 |

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| | | |
|--|-------------|-------------|
| Total shareholders' equity | 139,561 | 138,578 |
| Total liabilities and shareholders' equity | \$1,523,557 | \$1,476,143 |

See accompanying notes to unaudited consolidated financial statements.

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CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
UNAUDITED

| (dollars in thousands, except per share data) | Nine months ended | | Three months ended | |
|--|-----------------------|----------|-----------------------|----------|
| | September 30, 2014 | 2013 | September 30, 2014 | 2013 |
| Interest and dividend income: | | | | |
| Loans, including fees | \$34,590 | \$33,605 | \$11,973 | \$11,245 |
| Taxable securities | 3,889 | 3,120 | 1,122 | 1,003 |
| Tax exempt securities | 752 | 845 | 230 | 258 |
| Interest-bearing deposits | 59 | 21 | 16 | 3 |
| Total interest and dividend income | 39,290 | 37,591 | 13,341 | 12,509 |
| Interest Expense: | | | | |
| Deposits | 1,550 | 1,791 | 511 | 571 |
| Securities sold under agreements to repurchase | 634 | 645 | 214 | 214 |
| Borrowed funds | 572 | 594 | 190 | 207 |
| Total interest expense | 2,756 | 3,030 | 915 | 992 |
| Net interest income | 36,534 | 34,561 | 12,426 | 11,517 |
| Provision for loan losses | 2,330 | 1,755 | 589 | 874 |
| Net interest income after provision for loan losses | 34,204 | 32,806 | 11,837 | 10,643 |
| Other operating income: | | | | |
| Wealth management group fee income | 5,816 | 5,448 | 1,943 | 1,813 |
| Service charges on deposit accounts | 3,962 | 3,377 | 1,381 | 1,222 |
| Net gain on security transactions | 522 | 1 | - | - |
| Net gain on sales of loans held for sale | 209 | 425 | 84 | 134 |
| Net (losses) gains on sales of other real estate owned | (40) | 33 | 4 | 17 |
| Income from bank owned life insurance | 59 | 63 | 20 | 21 |
| Other | 4,828 | 3,500 | 1,554 | 1,144 |
| Total other operating income | 15,356 | 12,847 | 4,986 | 4,351 |
| Other operating expense: | | | | |
| Salaries and wages | 15,653 | 14,138 | 5,344 | 4,721 |
| Pension and other employee benefits | 4,132 | 4,161 | 1,294 | 1,372 |
| Net occupancy expenses | 5,174 | 4,016 | 1,721 | 1,315 |
| Furniture and equipment expenses | 2,052 | 1,600 | 707 | 514 |
| Data processing expense | 4,383 | 3,433 | 1,488 | 1,192 |
| Professional services | 911 | 713 | 268 | 188 |
| Legal settlement | 4,250 | - | 4,250 | - |
| Amortization of intangible assets | 993 | 663 | 324 | 214 |
| Marketing and advertising expenses | 879 | 782 | 255 | 297 |
| Other real estate owned expenses | 154 | 138 | 22 | 75 |
| FDIC insurance | 814 | 625 | 271 | 206 |
| Loan expense | 564 | 538 | 269 | 217 |
| Merger and acquisition related expenses | 115 | 217 | - | 202 |
| Other | 4,611 | 3,904 | 1,550 | 1,300 |
| Total operating expenses | 44,685 | 34,928 | 17,763 | 11,813 |
| Income (loss) before income tax expense | 4,875 | 10,725 | (940) | 3,181 |
| Income tax expense (benefit) | 1,199 | 3,479 | (621) | 1,002 |

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| | | | | |
|---|---------|---------|-----------|---------|
| Net income (loss) | \$3,676 | \$7,246 | \$(319) | \$2,179 |
| Weighted average shares outstanding | 4,681 | 4,658 | 4,684 | 4,660 |
| Basic and diluted earnings (loss) per share | \$0.79 | \$1.56 | \$(0.07) | \$0.47 |

See accompanying notes to unaudited consolidated financial statements.

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CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)

| (dollars in thousands) | Nine Months Ended September 30, | | Three Months Ended September 30, | |
|---|---------------------------------------|---------|--|---------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income (loss) | \$3,676 | \$7,246 | \$(319) | \$2,179 |
| Other comprehensive income: | | | | |
| Unrealized holding gains (losses) on securities available for sale | 635 | (1,901) | (1,380) | 1,404 |
| Reclassification adjustment gains realized in net income | (522) | (1) | - | - |
| Net unrealized gains (losses) | 113 | (1,902) | (1,380) | 1,404 |
| Tax effect | 43 | (731) | (531) | 540 |
| Net of tax amount | 70 | (1,171) | (849) | 864 |
| Change in funded status of defined benefit pension plan and other benefit plans: | | | | |
| Net gain (loss) arising during the period | - | - | - | - |
| Reclassification adjustment for amortization of prior service costs | (66) | (63) | (22) | (21) |
| Reclassification adjustment for amortization of net actuarial loss | 499 | 1,202 | 169 | 401 |
| Total before tax effect | 433 | 1,139 | 147 | 380 |
| Tax effect | 170 | 438 | 60 | 146 |
| Net of tax amount | 263 | 701 | 87 | 234 |
| Total other comprehensive income (loss) | 333 | (470) | (762) | 1,098 |
| Comprehensive income (loss) | \$4,009 | \$6,776 | \$(1,081) | \$3,277 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(UNAUDITED)

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total |
|--|-----------------|----------------------------------|----------------------|-------------------|---|--------------|
| (dollars in thousands except share data) | | | | | | |
| Balances at December 31, 2012 | \$ 53 | \$ 45,357 | \$ 107,078 | \$(18,566) | \$ (2,807) |) \$ 131,115 |
| Net income | - | - | 7,246 | - | - | 7,246 |
| Other comprehensive loss | - | - | - | - | (470) |) (470) |
| Restricted stock awards | - | 106 | - | - | - | 106 |
| Restricted stock units for directors' deferred compensation plan | - | 74 | - | - | - | 74 |
| Cash dividends declared (\$.78 per share) | - | - | (3,584) | - | - | (3,584) |
| Distribution of 7,969 shares of treasury stock for directors' compensation | - | 14 | - | 203 | - | 217 |
| Distribution of 4,116 shares of treasury stock for employee compensation | - | 7 | - | 105 | - | 112 |
| Distribution of 3,356 shares of treasury stock for deferred directors' compensation | - | (75) | - | 86 | - | 11 |
| Purchase of 3,094 shares of treasury stock | - | - | - | (93) | - | (93) |
| Sale of 2,369 shares of treasury stock | - | 11 | - | 60 | - | 71 |
| Forfeit 1,797 shares of restricted stock awards | - | 61 | - | (61) | - | - |
| Balances at September 30, 2013 | \$ 53 | \$ 45,555 | \$ 110,740 | \$(18,266) | \$ (3,277) |) \$ 134,805 |
| | | | | | | |
| Balances at December 31, 2013 | \$ 53 | \$ 45,399 | \$ 111,031 | \$(18,060) | \$ 155 | \$ 138,578 |
| Net income | - | - | 3,676 | - | - | 3,676 |
| Other comprehensive income | - | - | - | - | 333 | 333 |
| Restricted stock awards | - | 112 | - | - | - | 112 |
| Restricted stock units for directors' deferred compensation plan | - | 71 | - | - | - | 71 |
| Distribution of 990 shares of treasury stock granted for employee restricted stock awards, net | - | (26) | - | 26 | - | - |
| Cash dividends declared (\$.78 per share) | - | - | (3,602) | - | - | (3,602) |
| Distribution of 8,385 shares of treasury stock for directors' compensation | - | 59 | - | 214 | - | 273 |
| Distribution of 3,467 shares of treasury stock for deferred directors' compensation | - | (85) | - | 88 | - | 3 |
| Distribution of 3,595 shares of treasury stock for employee compensation | - | 25 | - | 92 | - | 117 |
| Balances at September 30, 2014 | \$ 53 | \$ 45,555 | \$ 111,105 | \$(17,640) | \$ 488 | \$ 139,561 |

See accompanying notes to unaudited consolidated financial statements.

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CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

| (dollars in thousands) | Nine Months Ended | |
|--|-------------------|-----------|
| | September 30, | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | 2014 | 2013 |
| Net income | \$3,676 | \$7,246 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of intangible assets | 993 | 663 |
| Provision for loan losses | 2,330 | 1,755 |
| Depreciation and amortization of fixed assets | 2,765 | 2,233 |
| Amortization of premiums on securities, net | 1,808 | 1,693 |
| Gains on sales of loans held for sale, net | (209) | (425) |
| Proceeds from sales of loans held for sale | 9,447 | 15,383 |
| Loans originated and held for sale | (9,710) | (14,767) |
| Net gains on trading assets | (32) | (27) |
| Net gains on securities transactions | (522) | (1) |
| Proceeds from sales of trading assets | 7 | 112 |
| Purchase of trading assets | (92) | (50) |
| Net loss (gain) on sales of other real estate owned | 40 | (33) |
| Increase in other assets | (475) | (1,344) |
| Decrease in prepaid FDIC assessment | - | 1,970 |
| Decrease in accrued interest payable | (61) | (114) |
| Expense related to restricted stock units for directors' deferred compensation plan | 71 | 74 |
| Expense related to employee stock compensation | 117 | 112 |
| Expense related to employee stock awards | 112 | 106 |
| Increase in other liabilities | 2,077 | 398 |
| Proceeds from bank owned life insurance | 111 | - |
| Income from bank owned life insurance | (59) | (63) |
| Net cash provided by operating activities | 12,394 | 14,921 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sales and calls of securities available for sale | 55,610 | 10,534 |
| Proceeds from maturities and principal collected on securities available for sale | 19,437 | 36,204 |
| Proceeds from maturities and principal collected on securities held to maturity | 3,022 | 5,379 |
| Purchases of securities available for sale | (18,301) | (69,921) |
| Purchases of securities held to maturity | (1,957) | (6,174) |
| Purchase of FHLB and FRBNY stock | (1,103) | (8,915) |
| Redemption of FHLB and FRBNY stock | 1,223 | 6,901 |
| Purchases of premises and equipment | (2,118) | (1,835) |
| Proceeds from sales of other real estate owned | 284 | 137 |
| Net increase in loans | (123,345) | (74,553) |
| Net cash used by investing activities | (67,248) | (102,243) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase in demand deposits, interest-bearing demand accounts, savings accounts, and insured money market accounts | 77,980 | 58,463 |
| Net decrease in time deposits | (33,237) | (14,752) |
| Net decrease in securities sold under agreements to repurchase | (1,720) | (2,211) |
| Increase of FHLB overnight advances | - | 49,100 |
| Repayments of FHLB long term advances | (1,157) | (1,179) |
| Purchase of treasury stock | - | (93) |
| Sale of treasury stock | - | 71 |

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| | | |
|--|-----------|----------|
| Cash dividends paid | (3,595) | (2,389) |
| Net cash provided by financing activities | 38,271 | 87,010 |
| Net decrease in cash and cash equivalents | (16,583) | (312) |
| Cash and cash equivalents, beginning of period | 51,609 | 40,241 |
| Cash and cash equivalents, end of period | \$35,026 | \$39,929 |

Supplemental disclosure of cash flow information:

Cash paid for:

| | | |
|--------------|---------|---------|
| Interest | \$2,817 | \$3,143 |
| Income taxes | \$1,846 | \$4,310 |

Supplemental disclosure of non-cash activity:

| | | |
|---|---------|---------|
| Transfer of loans to other real estate owned | \$3,074 | \$103 |
| Dividends declared, not yet paid | \$1,201 | \$1,195 |
| Assets acquired through long term capital lease obligations | \$3,039 | \$- |

See accompanying notes to unaudited consolidated financial statements.

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CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The Corporation, through its wholly owned subsidiaries, the Bank and CFS Group, Inc., provides a wide range of banking, financing, fiduciary and other financial services to its clients. The Corporation and the Bank are subject to the regulations of certain federal and state agencies and undergo periodic examinations by those regulatory authorities.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with GAAP and include the accounts of the Corporation and its subsidiaries. All significant intercompany balances and transactions are eliminated in consolidation. Amounts in the prior periods' consolidated financial statements are reclassified whenever necessary to conform with the current period's presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and disclosures provided, and actual results could differ. The allowance for loan losses, fair value of financial instruments, other-than-temporary impairment of investment securities and goodwill and other intangibles are particularly subject to change.

Subsequent Events

The Corporation has evaluated events and transactions through the time the unaudited consolidated financial statements were issued. Financial statements are considered issued when they are widely distributed to all shareholders and other financial statement users, or filed with the SEC. In conjunction with applicable accounting standards, all material subsequent events have been either recognized in the unaudited consolidated financial statements or disclosed in the notes to the unaudited consolidated financial statements.

Recent Accounting Pronouncements

In January 2014 the FASB issued ASU 2014-04, an amendment to Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40), Reclassification of Residential Real Estate and Collateralized Consumer Mortgage Loans upon Foreclosure. The objective of this ASU is to improve reporting by clarifying when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable is derecognized and the real estate property recognized. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Corporation will adopt all provisions of this ASU as of January 1, 2015. The adoption of this guidance is not expected to have a material impact on the Corporation's consolidated financial statements.

In May 2014 the FASB issued ASU 2014-09, an amendment to Revenue from Contracts with Customers (Topic 606). The objective of the ASU is to align the recognition of revenue with the transfer of promised goods or services provided to customers in an amount that reflects the consideration which the entity expects to be entitled in exchange for those goods or services. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. The Corporation will adopt all

provisions of this ASU as of January 1, 2017. We are currently evaluating the potential impact on our consolidated financial statements.

In June 2014 the FASB issued ASU 2014-11, an amendment to Transfers and Servicing (Topic 860): Repurchase-to Maturity Transactions, Repurchase Financings, and Disclosures. The objective of this ASU is to improve consistency in reporting repurchase transactions as secured borrowings and providing additional information of the collateral pledged. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Corporation will adopt all provisions of this ASU as of January 1, 2015.

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In August 2014 the FASB issued ASU 2014-15, an amendment to Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. The objective of this ASU is to define management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. The amendments in this ASU are effective for annual periods ending after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016. The Corporation will adopt all provisions of this ASU as of the December 31, 2015 annual period and interim periods beginning in 2016.

NOTE 2 EARNINGS (LOSS) PER COMMON SHARE (shares in thousands)

Basic earnings (loss) per share is net income (loss) divided by the weighted average number of common shares outstanding during the period. Issuable shares, including those related to directors' restricted stock units and directors' stock compensation, are considered outstanding and are included in the computation of basic earnings (loss) per share. All outstanding unvested share based payment awards that contain rights to non-forfeitable dividends are considered participating securities for this calculation. Restricted stock awards are grants of participating securities and are considered outstanding at grant date. Earnings (loss) per share information is adjusted to present comparative results for stock splits and stock dividends that occur. Earnings (loss) per share were computed by dividing net income (loss) by 4,681 and 4,658 weighted average shares outstanding for the nine-month periods ended September 30, 2014 and 2013, respectively. Earnings (loss) per share were computed by dividing net income (loss) by 4,684 and 4,660 weighted average shares outstanding for the three-month periods ended September 30, 2014 and 2013, respectively. There were no dilutive common stock equivalents during the three or nine-month periods ended September 30, 2014 or 2013.

NOTE 3 SECURITIES

Amortized cost and estimated fair value of securities available for sale are as follows (dollars in thousands):

| | September 30, 2014 | | | Estimated Fair Value |
|--|--------------------|---------------------|----------------------|----------------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | |
| Obligations of U.S. Government and U.S. | | | | |
| Government sponsored enterprises | \$175,960 | \$ 1,499 | \$ 244 | \$177,215 |
| Mortgage-backed securities, residential | 63,858 | 793 | 80 | 64,571 |
| Collateralized mortgage obligations | 457 | 7 | - | 464 |
| Obligations of states and political subdivisions | 32,710 | 982 | 12 | 33,680 |
| Corporate bonds and notes | 1,505 | 38 | 4 | 1,539 |
| SBA loan pools | 1,340 | 12 | 3 | 1,349 |
| Trust preferred securities | 1,904 | 121 | - | 2,025 |
| Corporate stocks | 433 | 6,823 | 2 | 7,254 |
| Total | \$278,167 | \$ 10,275 | \$ 345 | \$288,097 |

| | December 31, 2013 | | | Estimated Fair Value |
|--|-------------------|---------------------|----------------------|----------------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | |

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Obligations of U.S. Government and U.S.

| | | | | |
|--|-----------|-----------|----------|-----------|
| Government sponsored enterprises | \$187,098 | \$ 1,915 | \$ 907 | \$188,106 |
| Mortgage-backed securities, residential | 104,069 | 1,036 | 749 | 104,356 |
| Collateralized mortgage obligations | 1,001 | 14 | - | 1,015 |
| Obligations of states and political subdivisions | 37,339 | 1,059 | 22 | 38,376 |
| Corporate bonds and notes | 2,879 | 76 | 9 | 2,946 |
| SBA loan pools | 1,471 | 17 | - | 1,488 |
| Trust preferred securities | 1,898 | 136 | - | 2,034 |
| Corporate stocks | 444 | 7,253 | 2 | 7,695 |
| Total | \$336,199 | \$ 11,506 | \$ 1,689 | \$346,016 |

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Amortized cost and estimated fair value of securities held to maturity are as follows (dollars in thousands):

| | September 30, 2014 | | | Estimated Fair Value |
|--|--------------------|---------------------|----------------------|----------------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | |
| Obligations of states and political subdivisions | \$4,774 | \$ 382 | \$ - | \$ 5,156 |
| Time deposits with other financial institutions | 656 | 9 | - | 665 |
| Total | \$5,430 | \$ 391 | \$ - | \$ 5,821 |

| | December 31, 2013 | | | Estimated Fair Value |
|--|-------------------|---------------------|----------------------|----------------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | |
| Obligations of states and political subdivisions | \$5,472 | \$ 419 | \$ - | \$ 5,891 |
| Time deposits with other financial institutions | 1,023 | 16 | - | 1,039 |
| Total | \$6,495 | \$ 435 | \$ - | \$ 6,930 |

The amortized cost and estimated fair value of debt securities are shown below by expected maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately (dollars in thousands):

| | September 30, 2014 | | | |
|---|--------------------|---------------|-------------------|---------------|
| | Available for Sale | | Held to Maturity | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Within One Year | \$26,690 | \$27,044 | \$1,931 | \$1,960 |
| After One, But Within Five Years | 178,884 | 180,813 | 2,347 | 2,547 |
| After Five, But Within Ten Years | 6,505 | 6,602 | 1,152 | 1,314 |
| | 212,079 | 214,459 | 5,430 | 5,821 |
| Mortgage-backed securities, residential | 63,858 | 64,571 | - | - |
| Collateralized mortgage obligations | 457 | 464 | - | - |
| SBA loan pools | 1,340 | 1,349 | - | - |
| Total | \$277,734 | \$280,843 | \$5,430 | \$5,821 |

The proceeds from sales and calls of securities resulting in gains or losses at September 30, 2014 and September 30, 2013 are listed below (dollars in thousands):

| | 2014 | 2013 |
|--------------|----------|----------|
| Proceeds | \$55,610 | \$10,534 |
| Gross gains | \$522 | \$1 |
| Gross losses | \$- | \$- |
| Tax expense | \$201 | \$- |

The following tables summarize the investment securities available for sale with unrealized losses at September 30, 2014 and December 31, 2013 by aggregated major security type and length of time in a continuous unrealized loss position (dollars in thousands):

| | Less than 12 months | | 12 months or longer | | Total | |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2014 | | | | | | |
| Obligations of U.S. | | | | | | |
| Government and U.S. | | | | | | |
| Government sponsored enterprises | \$45,511 | \$ 159 | \$15,698 | \$ 85 | \$61,209 | \$ 244 |
| Mortgage-backed securities, residential | 22,875 | 80 | - | - | 22,875 | 80 |
| Obligations of states and political subdivisions | 3,608 | 11 | 326 | - | 3,934 | 11 |
| Corporate bonds and notes | - | - | 242 | 5 | 242 | 5 |
| SBA loan pools | 605 | 3 | - | - | 605 | 3 |
| Corporate stocks | - | - | 2 | 2 | 2 | 2 |
| Total temporarily impaired securities | \$72,599 | \$ 253 | \$16,268 | \$ 92 | \$88,867 | \$ 345 |

| | Less than 12 months | | 12 months or longer | | Total | |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2013 | | | | | | |
| Obligations of U.S. | | | | | | |
| Government and U.S. | | | | | | |
| Government sponsored enterprises | \$83,840 | \$ 867 | \$1,978 | \$ 39 | \$85,818 | \$ 906 |
| Mortgage-backed securities, residential | 63,115 | 750 | - | - | 63,115 | 750 |
| Obligations of states and political subdivisions | 4,589 | 22 | - | - | 4,589 | 22 |
| Corporate bonds and notes | 238 | 9 | - | - | 238 | 9 |
| Corporate stocks | - | - | 2 | 2 | 2 | 2 |
| Total temporarily impaired securities | \$151,782 | \$ 1,648 | \$1,980 | \$ 41 | \$153,762 | \$ 1,689 |

Other-Than-Temporary Impairment

As of September 30, 2014, the majority of the Corporation's unrealized losses in the investment securities portfolio related to obligations of U.S. Government and U.S. Government sponsored enterprises and mortgage-backed securities. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Corporation does not have the intent to sell these securities and it is not likely that it will be required to sell these securities before their anticipated recovery, the Corporation does not consider these securities to be other-than-temporarily impaired at September 30, 2014.

During the first quarter of 2014, the Corporation received notice that one CDO consisting of a pool of trust preferred securities was liquidated and recorded \$500 thousand in other operating income during the first quarter of 2014. The Corporation does not own any other CDO's in its investment securities portfolio.

The tables below present a roll forward of the cumulative credit losses recognized in earnings for the three and nine-month periods ending September 30, 2014 and 2013 (dollars in thousands):

| | 2014 | 2013 |
|---|---------|---------|
| Beginning balance, January 1, | \$1,939 | \$3,506 |
| Amounts related to credit loss for which an other-than-temporary impairment was not previously recognized | - | - |
| Additions/Subtractions: | | |
| Amounts realized for securities sold during the period | - | - |
| Amounts related to securities for which the company intends to sell or that it will be more likely than not that the company will be required to sell prior to recovery of amortized cost basis | - | - |
| Reductions for increase in cash flows expected to be collected that are recognized over the remaining life of the security | - | - |
| Reductions for previous credit losses realized in securities liquidated during the period | (1,939) | - |
| Increases to the amount related to the credit loss for which other-than-temporary impairment was previously recognized | - | - |
| Ending balance, September 30, | \$- | \$3,506 |

| | 2014 | 2013 |
|---|------|---------|
| Beginning balance, July 1, | \$ - | \$3,506 |
| Amounts related to credit loss for which an other-than-temporary impairment was not previously recognized | - | - |
| Additions/Subtractions: | | |
| Amounts realized for securities sold during the period | - | - |
| Amounts related to securities for which the company intends to sell or that it will be more likely than not that the company will be required to sell prior to recovery of amortized cost basis | - | - |
| Reductions for increase in cash flows expected to be collected that are recognized over the remaining life of the security | - | - |
| Reductions for previous credit losses realized in securities liquidated during the period | - | - |
| Increases to the amount related to the credit loss for which other-than-temporary impairment was previously recognized | - | - |
| Ending balance, September 30, | \$ - | \$3,506 |

NOTE 4

LOANS AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio, net of deferred origination fees and cost, and unearned income is summarized as follows (dollars in thousands):

| | September 30, 2014 | December 31, 2013 |
|---|-----------------------|----------------------|
| Commercial and agricultural: | | |
| Commercial and industrial | \$ 164,984 | \$ 144,787 |
| Agricultural | 868 | 576 |
| Commercial mortgages: | | |
| Construction | 46,981 | 27,440 |
| Commercial mortgages | 388,185 | 345,707 |
| Residential mortgages | 192,870 | 195,997 |
| Consumer loans: | | |
| Credit cards | 1,621 | 1,756 |
| Home equity lines and loans | 100,991 | 95,905 |
| Indirect consumer loans | 196,603 | 164,846 |
| Direct consumer loans | 21,079 | 18,852 |
| Total loans, net of deferred origination fees and costs, and unearned income | \$ 1,114,182 | \$ 995,866 |
| Interest receivable on loans | 2,512 | 2,597 |
| Total recorded investment in loans | \$ 1,116,694 | \$ 998,463 |

The Corporation's concentrations of credit risk by loan type are reflected in the preceding table. The concentrations of credit risk with standby letters of credit, committed lines of credit and commitments to originate new loans generally follow the loan classifications in the table above.

The following tables present the activity in the allowance for loan losses by portfolio segment for the three and nine-month periods ending September 30, 2014 and 2013 (dollars in thousands):

| | Nine Months Ended September 30, 2014 | | | | | Total |
|------------------------------|---|-------------------------|--------------------------|-------------------|-------------|-----------|
| | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Unallocated | |
| Allowance for loan losses | | | | | | |
| Beginning balance: | \$ 1,979 | \$ 6,243 | \$ 1,517 | \$ 3,037 | \$ - | \$ 12,776 |
| Charge Offs: | (415) | (1,236) | (97) | (1,191) | - | (2,939) |
| Recoveries: | 331 | 118 | 28 | 507 | - | 984 |
| Net recoveries (charge offs) | (84) | (1,118) | (69) | (684) | - | (1,955) |
| Provision | (183) | 1,200 | (16) | 1,329 | - | 2,330 |
| Ending balance | \$ 1,712 | \$ 6,325 | \$ 1,432 | \$ 3,682 | \$ - | \$ 13,151 |

| | Nine Months Ended September 30, 2013 | | | | | Total |
|---------------------------|---|-------------------------|--------------------------|-------------------|-------------|-------|
| | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Unallocated | |
| Allowance for loan losses | | | | | | |

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| | | | | | | |
|------------------------------|---------|----------|----------|----------|-------|----------|
| Beginning balance: | \$1,708 | \$ 4,428 | \$ 1,565 | \$ 2,706 | \$ 26 | \$10,433 |
| Charge Offs: | (186) | (44) | (53) | (910) | - | (1,193) |
| Recoveries: | 454 | 53 | 65 | 289 | - | 861 |
| Net recoveries (charge offs) | 268 | 9 | 12 | (621) | - | (332) |
| Provision | 82 | 976 | (25) | 748 | (26) | 1,755 |
| Ending balance | \$2,058 | \$ 5,413 | \$ 1,552 | \$ 2,833 | \$ - | \$11,856 |

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| | Three Months Ended September 30, 2014 | | | | | |
|------------------------------|--|----------|----------|----------|------|----------|
| | Commercial and Commercial Residential Consumer Agriculture Mortgages Mortgages Loans Unallocated | | | | | Total |
| Allowance for loan losses | \$1,749 | \$ 6,912 | \$ 1,498 | \$ 3,473 | \$ - | \$13,632 |
| Beginning balance: | | | | | | |
| Charge Offs: | (60) | (878) | (90) | (415) | - | (1,443) |
| Recoveries: | 138 | 35 | - | 200 | - | 373 |
| Net recoveries (charge offs) | 78 | (843) | (90) | (215) | - | (1,070) |
| Provision | (115) | 256 | 24 | 424 | - | 589 |
| Ending balance | \$1,712 | \$ 6,325 | \$ 1,432 | \$ 3,682 | \$ - | \$13,151 |

| | Three Months Ended September 30, 2013 | | | | | |
|------------------------------|--|----------|----------|----------|------|----------|
| | Commercial and Commercial Residential Consumer Agriculture Mortgages Mortgages Loans Unallocated | | | | | Total |
| Allowance for loan losses | \$1,879 | \$ 5,134 | \$ 1,515 | \$ 2,792 | \$ - | \$11,320 |
| Beginning balance: | | | | | | |
| Charge Offs: | (167) | (44) | - | (512) | - | (723) |
| Recoveries: | 158 | 34 | 27 | 166 | - | 385 |
| Net recoveries (charge-offs) | (9) | (10) | 27 | (346) | - | (338) |
| Provision | 188 | 289 | 10 | 387 | - | 874 |
| Ending balance | \$2,058 | \$ 5,413 | \$ 1,552 | \$ 2,833 | \$ - | \$11,856 |

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2014 and December 31, 2013 (dollars in thousands):

| | September 30, 2014 | | | | | |
|--------------------------------|--|----------|----------|----------|------|----------|
| | Commercial and Commercial Residential Consumer Agriculture Mortgages Mortgages Loans Unallocated | | | | | Total |
| Allowance for loan losses | | | | | | |
| Ending allowance balance | | | | | | |
| attributable to loans: | | | | | | |
| Individually evaluated for | | | | | | |
| impairment | \$68 | \$ 188 | \$ - | \$ 1 | \$ - | \$257 |
| Collectively evaluated for | | | | | | |
| impairment | 1,644 | 5,199 | 1,419 | 3,681 | - | 11,943 |
| Loans acquired with | | | | | | |
| deteriorated credit quality | - | 938 | 13 | - | - | 951 |
| Total ending allowance balance | \$1,712 | \$ 6,325 | \$ 1,432 | \$ 3,682 | \$ - | \$13,151 |

| | December 31, 2013 | | | | | |
|---------------------------|--|--|--|--|--|-------|
| | Commercial and Commercial Residential Consumer Agriculture Mortgages Mortgages Loans Unallocated | | | | | Total |
| Allowance for loan losses | | | | | | |
| Ending allowance balance | | | | | | |

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| | | | | | | |
|---|---------|----------|----------|----------|------|----------|
| attributable to loans: | | | | | | |
| Individually evaluated for impairment | \$576 | \$ 466 | \$ - | \$ 4 | \$ - | \$1,046 |
| Collectively evaluated for impairment | 1,403 | 4,407 | 1,497 | 3,033 | - | 10,340 |
| Loans acquired with deteriorated credit quality | - | 1,370 | 20 | - | - | 1,390 |
| Total ending allowance balance | \$1,979 | \$ 6,243 | \$ 1,517 | \$ 3,037 | \$ - | \$12,776 |

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| | September 30, 2014 | | | | |
|--|----------------------------------|-------------------------|--------------------------|-------------------|-------------|
| | Commercial and Agricultura | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Loans: | | | | | |
| Loans individually evaluated for impairment | \$1,318 | \$ 12,477 | \$ 108 | \$ 124 | \$14,027 |
| Loans collectively evaluated for impairment | 164,288 | 418,721 | 193,020 | 320,868 | 1,096,897 |
| Loans acquired with deteriorated credit quality | 607 | 4,917 | 246 | - | 5,770 |
| Total ending loans balance | \$166,213 | \$ 436,115 | \$ 193,374 | \$320,992 | \$1,116,694 |

| | December 31, 2013 | | | | |
|--|----------------------------------|-------------------------|--------------------------|-------------------|-----------|
| | Commercial and Agricultura | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Loans: | | | | | |
| Loans individually evaluated for impairment | \$2,946 | \$ 10,703 | \$ 117 | \$ 131 | \$13,897 |
| Loans collectively evaluated for impairment | 142,108 | 354,636 | 196,147 | 281,979 | 974,870 |
| Loans acquired with deteriorated credit quality | 678 | 8,757 | 261 | - | 9,696 |
| Total ending loans balance | \$145,732 | \$ 374,096 | \$ 196,525 | \$282,110 | \$998,463 |

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The following tables present loans individually evaluated for impairment recognized by class of loans as of September 30, 2014 and December 31, 2013, the average recorded investment and interest income recognized by class of loans as of the three and nine-month periods ended September 30, 2014 and 2013 (dollars in thousands):

| | September 30, 2014 | | | December 31, 2013 | | |
|-------------------------------------|--------------------------|---------------------|-------------------------------------|--------------------------|---------------------|-------------------------------------|
| | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated |
| With no related allowance recorded: | | | | | | |
| Commercial and agricultural: | | | | | | |
| Commercial and industrial | \$ 1,247 | \$ 1,250 | \$ - | \$ 1,906 | \$ 1,909 | \$ - |
| Commercial mortgages: | | | | | | |
| Construction | 1,936 | 1,919 | - | 2,329 | 2,319 | - |
| Commercial mortgages | 9,437 | 9,331 | - | 7,406 | 7,439 | - |
| Residential mortgages | 108 | 108 | - | 117 | 117 | - |
| Consumer loans: | | | | | | |
| Home equity lines and loans | 67 | 69 | - | 71 | 73 | - |
| With an allowance recorded: | | | | | | |
| Commercial and agricultural: | | | | | | |
| Commercial and industrial | 68 | 68 | 68 | 1,037 | 1,037 | 576 |
| Commercial mortgages: | | | | | | |
| Commercial mortgages | 1,237 | 1,227 | 188 | 951 | 945 | 466 |
| Consumer loans: | | | | | | |
| Home equity lines and loans | 55 | 55 | 1 | 58 | 58 | 4 |
| Total | \$ 14,155 | \$ 14,027 | \$ 257 | \$ 13,875 | \$ 13,897 | \$ 1,046 |

| | Nine Months Ended September 30, 2014 | | Nine Months Ended September 30, 2013 | | Three Months Ended September 30, 2014 | | Three Months Ended September 30, 2013 | |
|-------------------------------------|--------------------------------------|-----------------------------|--------------------------------------|-----------------------------|---------------------------------------|-----------------------------|---------------------------------------|-----------------------------|
| | Average Recorded Investment | Average Interest Recognized | Average Recorded Investment | Average Interest Recognized | Average Recorded Investment | Average Interest Recognized | Average Recorded Investment | Average Interest Recognized |
| With no related allowance recorded: | | | | | | | | |
| Commercial and agricultural: | | | | | | | | |
| Commercial and industrial | \$ 1,566 | \$ 26 | \$ 1,529 | \$ 52 | \$ 1,309 | \$ 11 | \$ 1,599 | \$ 17 |
| Commercial mortgages: | | | | | | | | |
| Construction | 2,231 | 76 | 3,626 | 64 | 1,924 | 26 | 2,576 | 22 |
| Commercial mortgages | 6,806 | 211 | 5,629 | 184 | 7,909 | 82 | 5,564 | 66 |
| Residential mortgages | 114 | - | 127 | - | 110 | - | 124 | - |
| Consumer loans: | | | | | | | | |
| Home equity lines and loans | 72 | 2 | 41 | 2 | 69 | 1 | 60 | 1 |
| With an allowance recorded: | | | | | | | | |
| Commercial and agricultural: | | | | | | | | |
| Commercial and industrial | 784 | - | 640 | - | 144 | - | 819 | - |
| Commercial mortgages: | | | | | | | | |
| Commercial mortgages | 912 | - | 847 | - | 1,233 | - | 1,333 | - |
| Consumer loans: | | | | | | | | |
| Home equity lines and loans | 58 | 3 | 43 | 2 | 56 | 1 | 58 | 1 |
| Direct consumer loans | - | - | 4 | - | - | - | - | - |
| Total | \$ 12,543 | \$ 318 | \$ 12,486 | \$ 304 | \$ 12,754 | \$ 121 | \$ 12,133 | \$ 107 |

Cash basis interest income approximates interest income recognized.

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The following tables present the recorded investment in past due and non-accrual status by class of loans as of September 30, 2014 and December 31, 2013 (dollars in thousands):

| September 30, 2014 | Current | 30-89 Days Past Due | 90 Days or more Past Due accruing | Loans acquired with deteriorated credit quality | Non-Accrual (1) | Total |
|------------------------------|-------------|---------------------|-----------------------------------|---|-----------------|-------------|
| Commercial and agricultural: | | | | | | |
| Commercial and industrial | \$164,207 | \$206 | \$ - | \$ 607 | \$ 324 | \$165,344 |
| Agricultural | 869 | - | - | - | - | 869 |
| Commercial mortgages: | | | | | | |
| Construction | 44,710 | - | 1,447 | 774 | 152 | 47,083 |
| Commercial mortgages | 378,459 | 2,542 | 1,077 | 4,143 | 2,811 | 389,032 |
| Residential mortgages | 187,777 | 2,219 | - | 246 | 3,132 | 193,374 |
| Consumer loans: | | | | | | |
| Credit cards | 1,601 | 17 | 3 | - | - | 1,621 |
| Home equity lines and loans | 100,153 | 608 | - | - | 465 | 101,226 |
| Indirect consumer loans | 195,291 | 1,426 | - | - | 286 | 197,003 |
| Direct consumer loans | 21,042 | 61 | - | - | 39 | 21,142 |
| Total | \$1,094,109 | \$7,079 | \$2,527 | \$5,770 | \$7,209 | \$1,116,694 |

(1) Includes all loans on non-accrual status regardless of the number of days such loans were delinquent as of September 30, 2014.

| December 31, 2013 | Current | 30-89 Days Past Due | 90 Days or more Past Due accruing | Loans acquired with deteriorated credit quality | Non-Accrual (1) | Total |
|------------------------------|-----------|---------------------|-----------------------------------|---|-----------------|-----------|
| Commercial and agricultural: | | | | | | |
| Commercial and industrial | \$143,100 | \$29 | \$ - | \$ 678 | \$ 1,348 | \$145,155 |
| Agricultural | 577 | - | - | - | - | 577 |
| Commercial mortgages: | | | | | | |
| Construction | 24,742 | - | 1,454 | 774 | 540 | 27,510 |
| Commercial mortgages | 335,123 | 1,138 | - | 7,983 | 2,342 | 346,586 |
| Residential mortgages | 187,448 | 5,458 | - | 261 | 3,358 | 196,525 |
| Consumer loans: | | | | | | |
| Credit cards | 1,729 | 9 | 19 | - | - | 1,757 |
| Home equity lines and loans | 95,349 | 150 | - | - | 635 | 96,134 |
| Indirect consumer loans | 163,810 | 1,235 | - | - | 249 | 165,294 |
| Direct consumer loans | 18,830 | 50 | - | - | 45 | 18,925 |
| Total | \$970,708 | \$8,069 | \$1,473 | \$9,696 | \$8,517 | \$998,463 |

(1) Includes all loans on non-accrual status regardless of the number of days such loans were delinquent as of December 31, 2013.

Troubled Debt Restructurings:

A modification of a loan may result in classification as a TDR when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Corporation offers various types of modifications which may involve a change in the schedule of payments, a reduction in the interest rate, an extension of the maturity date, 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, substituting or adding a new borrower or guarantor, a permanent reduction of the recorded investment in the loan or a permanent reduction of the interest on the loan.

As of September 30, 2014 and December 31, 2013, the Corporation has a recorded investment in troubled debt restructurings of \$8.7 million and \$7.9 million, respectively. There were specific reserves of less than \$0.1 million and \$0.3 million allocated for troubled debt restructurings at September 30, 2014 and December 31, 2013, respectively. As of September 30, 2014, troubled debt restructurings totaling \$8.1 million were accruing interest under the modified terms and \$0.6 million were on non-accrual status. As of December 31, 2013, troubled debt restructurings totaling \$6.8 million were accruing interest under the modified terms and \$1.1 million were on non-accrual status. The Corporation has committed to lend additional amounts totaling up to less than \$0.1 million and \$0.2 million as of September 30, 2014 and December 31, 2013, respectively, to customers with outstanding loans that are classified as troubled debt restructurings.

During the nine months ended September 30, 2014 and 2013, the terms of certain loans were modified as troubled debt restructurings. The modification of terms of such loans included one or a combination of the following: a change in the schedule of payments, a reduction in the interest rate, an extension of the maturity date, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk or a permanent reduction of the recorded investment in the loan.

The following table presents loans by class modified as troubled debt restructurings that occurred during the nine months ended September 30, 2014 and September 30, 2013 (dollars in thousands):

| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|--------------------------------------|-----------------------|---|--|
| Nine months ended September 30, 2014 | | | |
| Troubled debt restructurings: | | | |
| Commercial and agricultural: | | | |
| Commercial and industrial | 3 | \$ 908 | \$ 908 |
| Commercial mortgages: | | | |
| Commercial mortgages | 3 | 2,236 | 2,192 |
| Total | 6 | \$ 3,144 | \$ 3,100 |
| Nine months ended September 30, 2013 | | | |
| Troubled debt restructurings: | | | |
| Commercial and agricultural: | | | |
| Commercial and industrial | 4 | \$841 | \$841 |
| Commercial mortgages: | | | |
| Commercial mortgages | 1 | 133 | 133 |
| Consumer loans: | | | |
| Home equity lines and loans | 3 | 134 | 134 |
| Total | 8 | \$1,108 | \$1,108 |

The troubled debt restructurings described above did not increase the allowance for loan losses and resulted in less than \$0.1 million in charge offs during the nine months ended September 30, 2014. The troubled debt restructurings described above increased the allowance for loan losses by less than \$0.1 million and resulted in no charge offs during the nine months ended September 30, 2013.

There were no payment defaults on any loans previously modified as troubled debt restructurings during the nine months ending September 30, 2014 or September 30, 2013, within twelve months following the modification. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

The following table presents loans by class modified as troubled debt restructurings that occurred during the three months ended September 30, 2014 and September 30, 2013 (dollars in thousands):

| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---------------------------------------|-----------------------|---|--|
| Three months ended September 30, 2014 | | | |
| Troubled debt restructurings: | | | |
| Commercial and agricultural: | | | |
| Commercial and industrial | 2 | \$ 405 | \$ 405 |
| Commercial mortgages: | | | |
| Commercial mortgages | 1 | 1,869 | 1,869 |
| Total | 3 | \$ 2,274 | \$ 2,274 |

Three months ended September 30, 2013

Troubled debt restructurings:

Consumer loans:

| | | | |
|-----------------------------|---|------|------|
| Home equity lines and loans | 1 | \$31 | \$31 |
| Total | 1 | \$31 | \$31 |

The troubled debt restructurings described above did not increase the allowance for loan losses and resulted in no charge offs during the three months ended September 30, 2014. The troubled debt restructurings described above increased the allowance for loan losses by less than \$0.1 million and resulted in no charge offs during the three months ended September 30, 2013.

There were no payment defaults on any loans previously modified as troubled debt restructurings during the three months ending September 30, 2014 or September 30, 2013, within twelve months following the modification. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

Credit Quality Indicators

The Corporation establishes a risk rating at origination for all commercial loans. The main factors considered in assigning risk ratings include, but are not limited to: historic and future debt service coverage, collateral position, operating performance, liquidity, leverage, payment history, management ability, and the customer's industry. Commercial relationship managers monitor all loans in their respective portfolios for any changes in the borrower's ability to service their debt and affirm the risk ratings for the loans at least annually.

For the retail loans, which include residential mortgages, indirect and direct consumer loans, home equity lines and loans, and credit cards, once a loan is properly approved and closed, the Corporation evaluates credit quality based upon loan repayment.

The Corporation uses the risk rating system to identify criticized and classified loans. Commercial relationships within the criticized and classified risk ratings are analyzed quarterly. The Corporation uses the following definitions for criticized and classified loans (which are consistent with regulatory guidelines):

Special Mention – Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the

loan or the institution's credit position at some future date.

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

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

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Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. Loans listed as not rated are included in groups of homogeneous loans. Based on the analyses performed as of September 30, 2014 and December 31, 2013, the risk category of the recorded investment of loans by class of loans is as follows (dollars in thousands):

| September 30, 2014 | | | | | | | |
|------------------------------|--------------|-----------|--|--------------------|-------------|----------|-------------|
| | Not Rated | Pass | Loans acquired with deteriorated credit quality | Special Mention | Substandard | Doubtful | Total |
| Commercial and agricultural: | | | | | | | |
| Commercial and industrial | \$- | \$154,618 | \$ 607 | \$6,671 | \$ 3,380 | \$ 68 | \$165,344 |
| Agricultural | - | 869 | - | - | - | - | 869 |
| Commercial mortgages: | | | | | | | |
| Construction | - | 42,829 | 774 | 3,328 | 152 | - | 47,083 |
| Commercial mortgages | - | 362,160 | 4,143 | 12,088 | 10,491 | 150 | 389,032 |
| Residential mortgages | 189,739 | - | 246 | - | 3,389 | - | 193,374 |
| Consumer loans: | | | | | | | |
| Credit cards | 1,621 | - | - | - | - | - | 1,621 |
| Home equity lines and loans | 100,761 | - | - | - | 465 | - | 101,226 |
| Indirect consumer loans | 196,717 | - | - | - | 286 | - | 197,003 |
| Direct consumer loans | 21,103 | - | - | - | 39 | - | 21,142 |
| Total | \$509,941 | \$560,476 | \$ 5,770 | \$22,087 | \$ 18,202 | \$ 218 | \$1,116,694 |

| December 31, 2013 | | | | | | | |
|------------------------------|--------------|-----------|--|--------------------|-------------|----------|-----------|
| | Not Rated | Pass | Loans acquired with deteriorated credit quality | Special Mention | Substandard | Doubtful | Total |
| Commercial and agricultural: | | | | | | | |
| Commercial and industrial | \$- | \$133,615 | \$ 678 | \$5,117 | \$ 4,724 | \$ 1,021 | \$145,155 |
| Agricultural | - | 577 | - | - | - | - | 577 |
| Commercial mortgages: | | | | | | | |
| Construction | - | 23,087 | 774 | 2,783 | 866 | - | 27,510 |
| Commercial mortgages | - | 313,956 | 7,983 | 13,611 | 11,036 | - | 346,586 |
| Residential mortgages | 192,995 | - | 261 | - | 3,269 | - | 196,525 |
| Consumer loans: | | | | | | | |
| Credit cards | 1,757 | - | - | - | - | - | 1,757 |
| Home equity lines and loans | 95,422 | - | - | - | 712 | - | 96,134 |

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| | | | | | | | |
|-------------------------|-----------|-----------|----------|----------|-----------|----------|-----------|
| Indirect consumer loans | 165,045 | - | - | - | 249 | - | 165,294 |
| Direct consumer loans | 18,880 | - | - | - | 45 | - | 18,925 |
| Total | \$474,099 | \$471,235 | \$ 9,696 | \$21,511 | \$ 20,901 | \$ 1,021 | \$998,463 |

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The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity as of September 30, 2014 and December 31, 2013 (dollars in thousands):

| September 30, 2014 | | | | | |
|--------------------|--------------------|----------|------------|------------|-----------|
| Consumer Loans | | | | | |
| | Home Equity | | Indirect | Other | |
| | Residential Credit | Card | Lines and | Consumer | Consumer |
| | Mortgages | | Loans | Loans | Loans |
| Performing | \$ 190,242 | \$ 1,621 | \$ 100,761 | \$ 196,717 | \$ 21,103 |
| Non-Performing | 3,132 | - | 465 | 286 | 39 |
| Total | \$ 193,374 | \$ 1,621 | \$ 101,226 | \$ 197,003 | \$ 21,142 |

| December 31, 2013 | | | | | |
|-------------------|--------------------|----------|-----------|------------|-----------|
| Consumer Loans | | | | | |
| | Home Equity | | Indirect | Other | |
| | Residential Credit | Card | Lines and | Consumer | Consumer |
| | Mortgages | | Loans | Loans | Loans |
| Performing | \$ 193,167 | \$ 1,757 | \$ 95,499 | \$ 165,045 | \$ 18,880 |
| Non-Performing | 3,358 | - | 635 | 249 | 45 |
| Total | \$ 196,525 | \$ 1,757 | \$ 96,134 | \$ 165,294 | \$ 18,925 |

At the time of the merger with Fort Orange Financial Corp., the Corporation identified certain loans with evidence of deteriorated credit quality, and the probability that the Corporation would be unable to collect all contractually required payments from the borrower. These loans are classified as PCI loans. The Corporation adjusted its estimates of future expected losses, cash flows, and renewal assumptions on the PCI loans during the current year. These adjustments were made for changes in expected cash flows due to loans refinanced beyond original maturity dates, impairments recognized subsequent to the acquisition, advances made for taxes or insurance to protect collateral held and payments received in excess of amounts originally expected.

The table below summarizes the changes in total contractually required principal and interest cash payments, management's estimate of expected total cash payments and carrying value of the PCI loans from January 1, 2014 to September 30, 2014 and July 1, 2014 to September 30, 2014 (dollars in thousands):

| | Balance at December 31, 2013 | Income Accretion | All Other Adjustments | Balance at September 30, 2014 |
|---|------------------------------|------------------|-----------------------|-------------------------------|
| <u>Nine months ended September 30, 2014</u> | | | | |
| Contractually required principal and interest | \$ 11,230 | \$ - | \$ (4,359) |) \$ 6,871 |
| Contractual cash flows not expected to be collected (non accretable discount) | (543) |) - | (43) |) (586) |

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| | | | | | |
|--|----------|--------|-----------|----|----------|
| Cash flows expected to be collected | 10,687 | - | (4,402 |) | 6,285 |
| Interest component of expected cash flows (accretable yield) | (991 |) | 464 | 12 | (515 |
| Fair value of loans acquired with deteriorating credit quality | \$ 9,696 | \$ 464 | \$ (4,390 |) | \$ 5,770 |

| | Balance at June 30, 2014 | Income Accretion | All Other Adjustments | Balance at September 30, 2014 |
|--|-----------------------------------|---------------------|--------------------------|-------------------------------------|
| <u>Three months ended September 30, 2014</u> | | | | |
| Contractually required principal and interest | \$10,057 | \$ - | \$ (3,186 |) \$ 6,871 |
| Contractual cash flows not expected to be collected (non accretable discount) | (486 |) - | (100 |) (586 |
| Cash flows expected to be collected | 9,571 | - | (3,286 |) 6,285 |
| Interest component of expected cash flows (accretable yield) | (673 |) 120 | 38 | (515 |
| Fair value of loans acquired with deteriorating credit quality | \$8,898 | \$ 120 | \$ (3,248 |) \$ 5,770 |

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NOTE 5

FAIR VALUE

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

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Corporation used the following methods and significant assumptions to estimate fair value:

Investment Securities: The fair values of securities available for sale are usually determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs), or matrix pricing, which is a mathematical technique widely used to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

Trading Assets: Securities that are held to fund a deferred compensation plan are recorded at fair value with changes in fair value included in earnings. The fair values of trading assets are determined by quoted market prices (Level 1 inputs).

Impaired Loans: At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value have been partially charged-off or receive specific allocations as part of the allowance for loan loss accounting. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, typically resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Other Real Estate Owned: Assets acquired through or instead of loan foreclosures are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned ("OREO") are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Corporation. Once received, appraisals are reviewed for reasonableness of assumptions, approaches utilized, Uniform Standards of Professional Appraisal Practice and other regulatory compliance, as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. Appraisals are generally completed within the previous 12-month period prior to a property being placed into OREO. On impaired loans, appraisal values are adjusted based on the age of the appraisal, the position of the lien, the type of the property and its condition.

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Assets and liabilities measured at fair value on a recurring basis are summarized below (dollars in thousands):

| | Fair Value | Fair Value Measurement at September 30, 2014 Using | | |
|--|------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets: | | | | |
| Obligations of U.S. Government and U.S. Government sponsored enterprises | \$177,215 | \$31,174 | \$ 146,041 | \$ - |
| Mortgage-backed securities, residential | 64,571 | - | 64,571 | - |
| Collateralized mortgage obligations | 464 | - | 464 | - |
| Obligations of states and political subdivisions | 33,680 | - | 33,680 | - |
| Corporate bonds and notes | 1,539 | - | 1,539 | - |
| SBA loan pools | 1,349 | - | 1,349 | - |
| Trust Preferred securities | 2,025 | - | 2,025 | - |
| Corporate stocks | 7,254 | 6,838 | 416 | - |
| Total available for sale securities | \$288,097 | \$38,012 | \$ 250,085 | \$ - |
| Trading assets | \$483 | \$483 | \$ - | \$ - |

| | Fair Value | Fair Value Measurement at December 31, 2013 Using | | |
|--|------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets: | | | | |
| Obligations of U.S. Government and U.S. Government sponsored enterprises | \$188,106 | \$31,262 | \$ 156,844 | \$ - |
| Mortgage-backed securities, residential | 104,356 | - | 104,356 | - |
| Collateralized mortgage obligations | 1,015 | - | 1,015 | - |
| Obligations of states and political subdivisions | 38,376 | - | 38,376 | - |
| Corporate bonds and notes | 2,946 | - | 2,946 | - |
| SBA loan pools | 1,488 | - | 1,488 | - |
| Trust Preferred securities | 2,034 | - | 2,034 | - |

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| | | | | |
|-------------------------------------|-----------|----------|------------|------|
| Corporate stocks | 7,695 | 7,279 | 416 | - |
| Total available for sale securities | \$346,016 | \$38,541 | \$ 307,475 | \$ - |
| Trading assets | \$366 | \$366 | \$ - | \$ - |

There were no transfers between Level 1 and Level 2 during the nine-month period ending September 30, 2014 or the year ending December, 31, 2013.

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Assets and liabilities measured at fair value on a non-recurring basis are summarized below (dollars in thousands):

| | Fair Value | Fair Value Measurement at September 30, 2014 Using Quoted Prices in Active Markets for Significant Identifiable Assets | | |
|------------------------------------|------------|--|-----------------------------------|---|
| | | (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets: | | | | |
| Impaired Loans: | | | | |
| Commercial mortgages: | | | | |
| Commercial mortgages | \$1,049 | \$- | \$ - | \$ 1,049 |
| Consumer loans: | | | | |
| Home equity lines and loans | 54 | - | - | 54 |
| Total Impaired Loans | \$1,103 | \$- | \$ - | \$ 1,103 |
| Other real estate owned: | | | | |
| Commercial mortgages: | | | | |
| Commercial mortgages | \$3,117 | \$- | \$ - | \$ 3,117 |
| Consumer loans: | | | | |
| Home equity lines and loans | 2 | - | - | 2 |
| Total Other Real Estate Owned, net | \$3,119 | \$- | \$ - | \$ 3,119 |

| | Fair Value | Fair Value Measurement at December 31, 2013 Using Quoted Prices in Active Markets for Significant Identifiable Assets | | |
|------------------------------|------------|---|-----------------------------------|---|
| | | (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets: | | | | |
| Impaired Loans: | | | | |
| Commercial and agricultural: | | | | |
| Commercial and industrial | \$ 460 | \$- | \$ - | \$ 460 |
| Commercial mortgages: | | | | |
| Commercial mortgages | 485 | - | - | 485 |
| Consumer loans: | | | | |
| Home equity lines and loans | 54 | - | - | 54 |
| Total Impaired Loans | \$ 999 | \$- | \$ - | \$ 999 |

Other real estate owned:

Commercial and agricultural:

| | | | | |
|---------------------------|--------|-----|------|--------|
| Commercial and industrial | \$ 101 | \$- | \$ - | \$ 101 |
|---------------------------|--------|-----|------|--------|

Commercial mortgages:

| | | | | |
|----------------------|-----|---|---|-----|
| Commercial mortgages | 266 | - | - | 266 |
|----------------------|-----|---|---|-----|

| | | | | |
|-----------------------|-----|---|---|-----|
| Residential mortgages | 106 | - | - | 106 |
|-----------------------|-----|---|---|-----|

Consumer loans:

| | | | | |
|-----------------------------|----|---|---|----|
| Home equity lines and loans | 65 | - | - | 65 |
|-----------------------------|----|---|---|----|

| | | | | |
|------------------------------------|--------|-----|------|--------|
| Total Other Real Estate Owned, net | \$ 538 | \$- | \$ - | \$ 538 |
|------------------------------------|--------|-----|------|--------|

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The following table presents information related to Level 3 non-recurring fair value measurement at September 30, 2014 and December 31, 2013 (dollars in thousands):

| Description | Fair Value at September 30, 2014 | | Unobservable Inputs |
|-------------------------|----------------------------------|------------------------|---|
| | Fair Value | Technique | |
| Impaired loans | \$ 1,103 | Third party appraisals | Management discount based on underlying collateral 1 characteristics and market conditions |
| Other real estate owned | \$ 3,119 | Third party appraisals | 1 Estimated holding period 2 Estimated closing costs |

| Description | Fair Value at December 31, 2013 | | Unobservable Inputs |
|-------------------------|---------------------------------|------------------------|---|
| | Fair Value | Technique | |
| Impaired loans | \$ 999 | Third party appraisals | Management discount based on underlying collateral 1 characteristics and market conditions |
| Other real estate owned | \$ 538 | Third party appraisals | 1 Estimated holding period 2 Estimated closing costs |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal balance of \$1.4 million with a valuation allowance of \$0.3 million as of September 30, 2014, resulting in \$0.1 million and \$0.8 million decrease in the provision for loan losses for the three and nine-month periods ended September 30, 2014. Impaired loans had a principal balance of \$2.0 million, with a valuation allowance of \$1.0 million as of December 31, 2013, resulting in an increase of \$0.9 million in the provision for loan losses for the year ending December 31, 2013.

OREO is measured by the lower of cost or fair value less costs to sell. The net carrying amount reflects the outstanding balance of \$3.1 million with no valuation allowance at September 30, 2014, which resulted in no write downs during the three-month period ending September 30, 2014 and less than \$0.1 million for the nine-month period ending September 30, 2014. OREO had a net carrying amount of \$0.5 million at December 31, 2013. The net carrying amount reflects the outstanding balance of \$0.7 million, net of a valuation allowance of \$0.2 million, at December 31, 2013, which resulted in an immaterial write down for the year ending December 31, 2013.

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The carrying amounts and estimated fair values of other financial instruments, at September 30, 2014 and December 31, 2013, are as follows (dollars in thousands):

| | Fair Value Measurements at September 30, 2014 Using | | | | |
|---|---|--|---|---|--------------------------|
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Estimated Fair Value (1) |
| Financial assets: | | | | | |
| Cash and due from financial institutions | \$31,957 | \$31,957 | \$ - | \$ - | \$31,957 |
| Interest-bearing deposits in other financial institutions | 3,069 | 3,069 | - | - | 3,069 |
| Trading assets | 483 | 483 | - | - | 483 |
| Securities available for sale | 288,097 | 38,012 | 250,085 | - | 288,097 |
| Securities held to maturity | 5,430 | - | 5,821 | - | 5,821 |
| FHLB NY and FRB NY stock | 4,362 | - | - | - | N/ A |
| Loans, net | 1,101,031 | - | - | 1,127,642 | 1,127,642 |
| Loans held for sale | 1,167 | - | 1,167 | - | 1,167 |
| Accrued interest receivable | 4,340 | 360 | 1,468 | 2,512 | 4,340 |
| Financial liabilities: | | | | | |
| Deposits: | | | | | |
| Demand, savings, and insured money market accounts | \$1,099,744 | \$1,099,744 | \$ - | \$ - | \$1,099,744 |
| Time deposits | 211,255 | - | 211,876 | - | 211,876 |
| Securities sold under agreements to repurchase | 30,981 | - | 32,144 | - | 32,144 |
| FHLB NY term advances | 24,086 | - | 24,994 | - | 24,994 |
| Accrued interest payable | 275 | 12 | 263 | - | 275 |

(1) Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

| | Fair Value Measurements at December 31, 2013 Using | | | | |
|---|--|--|---|---|--------------------------|
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Estimated Fair Value (1) |
| Financial Assets: | | | | | |
| Cash and due from financial institutions | \$31,600 | \$31,600 | \$ - | \$ - | \$31,600 |
| Interest-bearing deposits in other financial institutions | 20,009 | 20,009 | - | - | 20,009 |

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| | | | | | |
|--|-------------|-------------|---------|-----------|-------------|
| Trading assets | 366 | 366 | - | - | 366 |
| Securities available for sale | 346,016 | 38,541 | 307,475 | - | 346,016 |
| Securities held to maturity | 6,495 | - | 6,930 | - | 6,930 |
| FHLB NY and FRBNY stock | 4,482 | - | - | - | N/ A |
| Loans, net | 983,090 | - | - | 1,008,826 | 1,008,826 |
| Loans held for sale | 695 | - | 695 | - | 695 |
| Accrued interest receivable | 4,166 | 145 | 1,468 | 2,553 | 4,166 |
| Financial liabilities: | | | | | |
| Deposits: | | | | | |
| Demand, savings, and insured money market accounts | \$1,021,764 | \$1,021,764 | \$- | \$- | \$1,021,764 |
| Time deposits | 244,492 | - | 245,482 | - | 245,482 |
| Securities sold under agreements to repurchase | 32,701 | - | 33,636 | - | 33,636 |
| FHLB NY Advances | 25,243 | - | 26,064 | - | 26,064 |
| Accrued interest payable | 336 | 15 | 321 | - | 336 |

(1) Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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The methods and assumptions used to estimate fair value are described as follows:

Cash, Due From and Interest-Bearing Deposits in Other Financial Institutions

For those short-term instruments that generally mature in 90 days or less, the carrying value approximates fair value of which non-interest-bearing deposits are classified as Level 1 and interest-bearing deposits with the FHLBNY and FRBNY are classified as Level 1.

FHLBNY and FRBNY Stock

It is not practicable to determine the fair value of FHLBNY and FRBNY stock due to restrictions placed on its transferability.

Loans Receivable

For variable-rate loans that reprice frequently, fair values approximate carrying values. The fair values for other loans are estimated through discounted cash flow analysis using interest rates currently being offered for loans with similar terms and credit quality. Loans are classified as Level 3. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Loans Held for Sale

Certain mortgage loans are originated with the intent to sell. Loans held for sale are recorded at the lower of cost or fair value in the aggregate. Loans held for sale are classified as Level 2.

Deposits

The fair values disclosed for demand deposits, savings accounts and money market accounts are, by definition, equal to the amounts payable on demand at the reporting date (i.e., their carrying values) and classified as Level 1.

The fair value of certificates of deposits is estimated using a discounted cash flow approach that applies interest rates currently being offered on certificates to a schedule of the weighted-average expected monthly maturities and classified as Level 2.

Securities Sold Under Agreements to Repurchase

These instruments bear both variable and fixed rates of interest. Therefore, the carrying value approximates fair value for the variable rate instruments and the fair value of fixed rate instruments is based on discounted cash flows to maturity. These are classified as Level 2.

FHLBNY Term Advances

These instruments bear a stated rate of interest to maturity and, therefore, the fair value is based on discounted cash flows to maturity and classified as Level 2.

Commitments to Extend Credit

The fair value of commitments to extend credit is based on fees currently charged to enter into similar agreements, the counter-party's credit standing and discounted cash flow analysis. The fair value of these commitments to extend

credit approximates the recorded amounts of the related fees and is not material at September 30, 2014 and December 31, 2013.

Accrued Interest Receivable and Payable

For these short-term instruments, the carrying value approximates fair value resulting in a classification of Level 1, Level 2 or Level 3 depending upon the classification of the asset/liability they are associated with.

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NOTE 6

GOODWILL AND INTANGIBLE ASSETS

The changes in goodwill included in the core banking segment during the periods ending September 30, 2014 and 2013 were as follows (dollars in thousands):

| | 2014 | 2013 |
|------------------------------|----------|----------|
| Beginning of year | \$21,824 | \$21,824 |
| Acquired goodwill | - | - |
| Ending balance September 30, | \$21,824 | \$21,824 |

Acquired intangible assets were as follows at September 30, 2014 and December 31, 2013 (dollars in thousands):

| | At September 30, 2014 | | At December 31, 2013 | |
|---|-----------------------|--------------------------|----------------------|--------------------------|
| | Balance | Accumulated Amortization | Balance | Accumulated Amortization |
| Core deposit intangibles | \$5,975 | \$ 3,054 | \$5,975 | \$ 2,338 |
| Other customer relationship intangibles | 5,633 | 3,170 | 6,063 | 3,323 |
| Total | \$11,608 | \$ 6,224 | \$12,038 | \$ 5,661 |

Aggregate amortization expense was \$1.0 million and \$0.7 million for the nine-month periods ended September 30, 2014 and 2013, respectively.

The remaining estimated aggregate amortization expense at September 30, 2014 is listed below (dollars in thousands):

| Year | Estimated Expense |
|---------------------|-------------------|
| 2014 | \$ 318 |
| 2015 | 1,136 |
| 2016 | 986 |
| 2017 | 859 |
| 2018 | 734 |
| 2019 and thereafter | 1,351 |
| Total | \$ 5,384 |

NOTE 7

ACCUMULATED OTHER COMPREHENSIVE INCOME OR LOSS

Accumulated other comprehensive income or loss represents the net unrealized holding gains or losses on securities available for sale and the funded status of the Corporation's defined benefit pension plan and other benefit plans, as of the consolidated balance sheet dates, net of the related tax effect.

The following is a summary of the changes in accumulated other comprehensive income or loss by component, net of tax, for the periods indicated (dollars in thousands):

| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Benefit Plans | Total |
|--|---|--|-----------|
| Balance at December 31, 2013 | \$ 6,043 | \$(5,888) | \$ 155 |
| Other comprehensive income before reclassification | 391 | - | 391 |
| Amounts reclassified from accumulated other comprehensive income | (321) | 263 | (58) |
| Net current period other comprehensive income | 70 | 263 | 333 |
| Balance at September 30, 2014 | \$ 6,113 | \$(5,625) | \$ 488 |
| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Benefit Plans | Total |
| Balance at June 30, 2014 | \$ 6,962 | \$(5,712) | \$ 1,250 |
| Other comprehensive (loss) before reclassification | (849) | - | (849) |
| Amounts reclassified from accumulated other comprehensive income | - | 87 | 87 |
| Net current period other comprehensive (loss) income | (849) | 87 | (762) |
| Balance at September 30, 2014 | \$ 6,113 | \$(5,625) | \$ 488 |
| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Benefit Plans | Total |
| Balance at December 31, 2012 | \$ 8,023 | \$(10,830) | \$(2,807) |
| Other comprehensive loss before reclassification | (1,170) | - | (1,170) |

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| | | | |
|--|----------|------------|-----------|
| Amounts reclassified from accumulated other comprehensive income | (1) | 701 | 700 |
| Net current period other comprehensive (loss) income | (1,171) | 701 | (470) |
| Balance at September 30, 2013 | \$ 6,852 | \$(10,129) | \$(3,277) |

| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Plans | Total |
|--|--|---------------------------------|-----------|
| Balance at June 30, 2013 | \$ 5,988 | \$(10,363) | \$(4,375) |
| Other comprehensive income before reclassification | 864 | - | 864 |
| Amounts reclassified from accumulated other comprehensive income | - | 234 | 234 |
| Net current period other comprehensive income | 864 | 234 | 1,098 |
| Balance at September 30, 2013 | \$ 6,852 | \$(10,129) | \$(3,277) |

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The following is the reclassification out of accumulated other comprehensive income for the periods indicated (dollars in thousands):

| Details about Accumulated Other Comprehensive Income Components | Nine Months Ended September 30, | | Affected Line Item in the Statement Where Net Income is Presented |
|--|---------------------------------|---------|---|
| | 2014 | 2013 | |
| Unrealized gains and losses on securities available for sale: | | | |
| Reclassification adjustment for other-than-temporary gains (losses) realized in income | \$- | \$- | |
| Realized gains on securities available for sale | 522 | 1 | Net gains on securities transactions |
| Tax effect | 201 | - | Income tax expense |
| Net of tax | 321 | 1 | |
| Amortization of defined pension plan and other benefit plan items: | | | |
| Prior service costs (a) | 66 | 63 | Pension and other employee benefits |
| Actuarial losses (a) | (499) | (1,202) | Pension and other employee benefits |
| Tax effect | 170 | 438 | Income tax expense |
| Net of tax | (263) | (701) | |
| Total reclassification for the period, net of tax | \$58 | \$(700) | |

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension and other benefit plan costs (see Note 9 for additional information).

| Details about Accumulated Other Comprehensive Income Components | Three Months Ended September 30, | | Affected Line Item in the Statement Where Net Income is Presented |
|--|----------------------------------|---------|---|
| | 2014 | 2013 | |
| Unrealized gains and losses on securities available for sale: | | | |
| Reclassification adjustment for other-than-temporary gains (losses) realized in income | \$- | \$- | |
| Realized gains on securities available for sale | - | - | Net gains on securities transactions |
| Tax effect | - | - | Income tax expense |
| Net of tax | - | - | |
| Amortization of defined pension plan and other benefit plan items: | | | |
| Prior service costs (a) | 22 | 21 | Pension and other employee benefits |
| Actuarial losses (a) | (169) | (401) | Pension and other employee benefits |
| Tax effect | 60 | 146 | Income tax expense |
| Net of tax | (87) | (234) | |
| Total reclassification for the period, net of tax | \$(87) | \$(234) | |

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension and other benefit plan costs (see Note 9 for additional information).

NOTE 8

COMMITMENTS AND CONTINGENCIES

The Corporation is a party to certain financial instruments with off-balance sheet risk such as commitments under standby letters of credit, unused portions of lines of credit, overdraft protection and commitments to fund new loans. In accordance with GAAP, these financial instruments are not recorded in the financial statements. The Corporation's policy is to record such instruments when funded. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are generally used by the Corporation to manage clients' requests for funding and other client needs.

The following table lists the contractual amounts of financial instruments with off-balance sheet risk at September 30, 2014 and December 31, 2013 (dollars in thousands):

| | September 30, 2014 | | December 31, 2013 | |
|---------------------------|--------------------|---------------|-------------------|---------------|
| | Fixed Rate | Variable Rate | Fixed Rate | Variable Rate |
| Commitments to make loans | \$29,126 | \$14,973 | \$21,049 | \$7,893 |
| Unused lines of credit | \$1,738 | \$173,196 | \$2,190 | \$187,061 |
| Standby letters of credit | \$- | \$16,687 | \$- | \$17,290 |

The Bank is a party in two legal proceedings involving its Wealth Management Group. In both proceedings, the Bank, as trustee pursuant to written trust instruments, has sought judicial settlement of trust accounts in the New York Surrogate's Court for Chemung County. Individuals who are beneficiaries under the trusts have filed formal objections and/or demand letters with the Court in both of these accounting proceedings, objecting to the final settlement of the trust accounts. The objectants primarily assert that the Bank acted imprudently by failing to diversify the trusts' investments and they claim \$13.2 million (an increase from the previously claimed \$9.6 million based on an asserted new measure of damages) and \$24.1 million, consisting of damages and disallowed trustee's commissions, plus unspecified legal fees in the respective proceedings. For both legal proceedings, the Bank agreed to participate in non-binding mediation which began November 10, 2014. As a result of mediation and in anticipation of a settlement with both parties, the Bank's Board of Directors approved the establishment of an accrual for legal settlement in the amount of \$4.3 million as of September 30, 2014. In the event that a formal agreement is not executed, legal proceedings will continue in the Surrogate's Court. The first trial is scheduled to begin January 12, 2015 and the second trial is scheduled to begin February 23, 2015.

In the normal course of business, there are various outstanding claims and legal proceedings involving the Corporation or its subsidiaries. Except for the above matter, we believe that we are not a party to any pending legal, arbitration, or regulatory proceedings that could have a material adverse impact on our financial results or liquidity.

NOTE 9 COMPONENTS OF QUARTERLY AND YEAR TO DATE NET PERIODIC BENEFIT COSTS

The components of net periodic expense for the Corporation's pension and other benefit plans for the periods indicated are as follows (dollars in thousands):

| | Nine Months Ended | | Three Months Ended | |
|-------------------|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2014 | September 30, 2013 | September 30, 2014 | September 30, 2013 |
| Qualified Pension | | | | |

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| | | | | |
|---|---------|----------|-------|--------|
| Service cost, benefits earned during the period | \$813 | \$ 1,048 | \$271 | \$ 349 |
| Interest cost on projected benefit obligation | 1,305 | 1,226 | 435 | 409 |
| Expected return on plan assets | (2,379) | (2,181) | (793) | (727) |
| Amortization of unrecognized prior service cost | 6 | 10 | 2 | 3 |
| Amortization of unrecognized net loss | 480 | 1,172 | 160 | 391 |
| Net periodic pension expense | \$225 | \$ 1,275 | \$75 | \$ 425 |

Supplemental Pension

| | | | | |
|---|------|-------|------|-------|
| Service cost, benefits earned during the period | \$30 | \$ 30 | \$10 | \$ 10 |
| Interest cost on projected benefit obligation | 40 | 36 | 14 | 12 |
| Amortization of unrecognized net loss | 19 | 26 | 9 | 9 |
| Net periodic supplemental pension expense | \$89 | \$ 92 | \$33 | \$ 31 |

Postretirement, Medical and Life

| | | | | |
|---|-------|-------|-------|-------|
| Service cost, benefits earned during the period | \$33 | \$ 36 | \$11 | \$ 12 |
| Interest cost on projected benefit obligation | 54 | 48 | 18 | 16 |
| Amortization of unrecognized prior service cost | (72) | (73) | (24) | (24) |
| Amortization of unrecognized net loss | - | 4 | - | 1 |
| Net periodic postretirement, medical and life expense | \$15 | \$ 15 | \$5 | \$ 5 |

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NOTE 10

SEGMENT REPORTING

The Corporation manages its operations through two primary business segments: core banking and wealth management group services. The core banking segment provides revenues by attracting deposits from the general public and using such funds to originate consumer, commercial, commercial real estate, and residential mortgage loans, primarily in the Corporation's local markets and to invest in securities. The wealth management group services segment provides revenues by providing trust and investment advisory services to clients.

Accounting policies for the segments are the same as those described in Note 1. Summarized financial information concerning the Corporation's reportable segments and the reconciliation to the Corporation's consolidated results are shown in the following table. Income taxes are allocated based on the separate taxable income of each entity and indirect overhead expenses are allocated based on reasonable and equitable allocations applicable to the reportable segment. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the Holding Company and Other column below, along with amounts to eliminate transactions between segments (dollars in thousands).

| | Nine Months Ended September 30, 2014 | | | |
|--|--------------------------------------|---|------------------------------------|------------------------|
| | Core Banking | Wealth Management Group Services | Holding Company And Other | Consolidated Totals |
| Net interest income | \$36,525 | \$ - | \$ 9 | \$ 36,534 |
| Provision for loan losses | 2,330 | - | - | 2,330 |
| Net interest income after provision for loan losses | 34,195 | - | 9 | 34,204 |
| Other operating income | 8,930 | 5,816 | 610 | 15,356 |
| Other operating expenses | 35,836 | 8,199 | 650 | 44,685 |
| Income (loss) before income tax expense | 7,289 | (2,383 |) (31 |) 4,875 |
| Income tax expense (benefit) | 2,179 | (916 |) (64 |) 1,199 |
| Segment net income (loss) | \$5,110 | \$ (1,467 |) \$ 33 | \$ 3,676 |
| Segment assets | \$1,515,658 | \$ 6,332 | \$ 1,567 | \$ 1,523,557 |

| | Nine Months Ended September 30, 2013 | | | |
|--|--------------------------------------|---|------------------------------------|------------------------|
| | Core Banking | Wealth Management Group Services | Holding Company And Other | Consolidated Totals |
| Net interest income | \$34,553 | \$ - | \$ 8 | \$ 34,561 |
| Provision for loan losses | 1,755 | - | - | 1,755 |
| Net interest income after provision for loan losses | 32,798 | - | 8 | 32,806 |
| Other operating income | 6,715 | 5,448 | 684 | 12,847 |
| Other operating expenses | 30,137 | 4,174 | 617 | 34,928 |
| Income before income tax expense | 9,376 | 1,274 | 75 | 10,725 |
| Income tax expense (benefit) | 2,995 | 490 | (6 |) 3,479 |
| Segment net income | \$6,381 | \$ 784 | \$ 81 | \$ 7,246 |

| | | | | |
|----------------|-------------|----------|----------|--------------|
| Segment assets | \$1,334,376 | \$ 5,023 | \$ 1,692 | \$ 1,341,091 |
|----------------|-------------|----------|----------|--------------|

| | Three Months Ended September 30, 2014 | | | |
|---|---------------------------------------|-------------|---------|--------------|
| | Core | Wealth | Holding | Consolidated |
| | Banking | Management | Company | Totals |
| | | Group | And | |
| | | Services | Other | |
| Net interest income | \$12,424 | \$ - | \$ 2 | \$ 12,426 |
| Provision for loan losses | 589 | - | - | 589 |
| Net interest income after provision | | | | |
| for loan losses | 11,835 | - | 2 | 11,837 |
| Other operating income | 2,852 | 1,943 | 191 | 4,986 |
| Other operating expenses | 12,055 | 5,510 | 198 | 17,763 |
| Income (loss) before income tax expense | 2,632 | (3,567) | (5) | (940) |
| Income tax expense (benefit) | 769 | (1,371) | (19) | (621) |
| Segment net income (loss) | \$1,863 | \$ (2,196) | \$ 14 | \$ (319) |

| | Three Months Ended September 30, 2013 | | | |
|---|---------------------------------------|------------|---------|--------------|
| | Core | Wealth | Holding | Consolidated |
| | Banking | Management | Company | Totals |
| | | Group | And | |
| | | Services | Other | |
| Net interest income | \$11,515 | \$ - | \$ 2 | \$ 11,517 |
| Provision for loan losses | 874 | - | - | 874 |
| Net interest income after provision | | | | |
| for loan losses | 10,641 | - | 2 | 10,643 |
| Other operating income | 2,402 | 1,813 | 136 | 4,351 |
| Other operating expenses | 10,276 | 1,371 | 166 | 11,813 |
| Income (loss) before income tax expense | 2,767 | 442 | (28) | 3,181 |
| Income tax expense (benefit) | 860 | 170 | (28) | 1,002 |
| Segment net income | \$1,907 | \$ 272 | \$ - | \$ 2,179 |

NOTE 11 STOCK COMPENSATION

Board of Director's Stock Compensation

Members of the Board of Directors receive common shares of the Corporation equal in value to the amount of fees individually earned during the previous year for service as a director. The common shares are distributed to the Corporation's individual board members from treasury shares of the Corporation on or about January 15 following the calendar year of service.

Additionally, the President and Chief Executive Officer of the Corporation, who does not receive cash compensation as a member of the Board of Directors, is awarded common shares equal in value to the average of those awarded to board members not employed by the Corporation who have served for 12 months during the prior year.

During January 2014 and 2013, 8,385 and 7,969 shares, respectively, were re-issued from treasury to fund the stock component of directors' compensation. An expense of \$187 thousand and \$185 thousand related to this compensation was recognized during the nine-month periods ending September 30, 2014 and September 30, 2013, respectively. This expense is accrued as shares are earned.

Restricted Stock Plan

Pursuant to the Corporation's Restricted Stock Plan (the "Plan"), the Corporation may make discretionary grants of restricted stock to officers other than the Corporation's Chief Executive Officer. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at issue date.

A summary of restricted stock activity from December 31, 2013 to September 30, 2014 is presented below:

| | Shares | Weighted–Average Grant Date Fair Value |
|---------------------------------|--------|--|
| Nonvested at December 31, 2013 | 20,639 | \$ 27.17 |
| Granted | 990 | 30.33 |
| Vested | (415) | 23.07 |
| Forfeited or Cancelled | - | - |
| Nonvested at September 30, 2014 | 21,214 | \$ 27.40 |

As of September 30, 2014, there was \$468 thousand of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 3.50 years. The total fair value of shares vested during the nine months ended September 30, 2014 was \$12 thousand.

NOTE 12 SUBSEQUENT EVENT

As discussed in Footnote 8 Commitments and Contingencies, on November 14, 2014 the Board of Directors approved the establishment of an accrual for legal settlement in the amount of \$4.3 million as of September 30, 2014, as a result of mediation and in anticipation of a legal settlement.. For accounting purposes, \$4.3 million was recorded as expense in the for legal settlement line in the Consolidated Statements of Income and increased accrued interest payable and other liabilities in the Consolidated Balance Sheets. A related tax benefit of \$1.7 million was recorded in the income tax expense (benefit) line in the Consolidated Statements of Income and increased accrued interest payable and other assets in the Consolidated Balance Sheets.

The Corporation's October 23, 2014 earnings release did not reflect the accrual for legal settlement, as the Corporation was unable to reasonably estimate a potential loss relating to the two legal proceedings at that point in time. The accrual for legal settlement changed the previously reported 2014 year-to-date amounts for net income of \$6.3 million to \$3.7 million, income tax expense of \$2.9 million to \$1.2 million, non-interest expense of \$40.4 million to \$44.7 million and earnings per share of \$1.34 to \$0.79. In addition, total shareholders' equity decreased from \$142.1 million to \$139.6 million, while total assets increased from \$1.522 billion to \$1.524 billion.

Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

The purpose of this discussion is to focus on information about the financial condition and results of operations of the Corporation for the three and nine-month periods ended September 30, 2014 and 2013. Reference should be made to the accompanying unaudited consolidated financial statements and footnotes, and the Corporation's 2013 Annual Report on Form 10-K, which was filed with the SEC on March 14, 2014, for an understanding of the following discussion and analysis.

Forward-looking Statements

This discussion contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The Corporation intends its forward-looking statements to be covered by the safe harbor provisions for forward-looking statements in the PSLRA. Forward-looking statements are not historical in nature, but instead are based on our assumptions, estimates and projections about future events and trends. All statements regarding the Corporation's expected financial position and operating results, the Corporation's business strategy, the Corporation's financial plans, forecasted demographic and economic trends relating to the Corporation's industry and similar matters are forward-looking statements. These statements can sometimes be identified by the Corporation's use of forward-looking words such as "may," "will," "anticipate," "estimate," "expect," or "intend." The Corporation cannot promise that its expectations in such forward-looking statements will turn out to be correct. The Corporation's actual results could be materially different from expectations because of various factors, including changes in economic conditions or interest rates, credit risk, difficulties in managing the Corporation's growth, competition, changes in law or the regulatory environment, including the Dodd-Frank Act, and changes in general business and economic trends. Information concerning these and other factors can be found in the Corporation's periodic filings with the SEC, including the discussion under the heading "Item 1A. Risk Factors" in the Corporation's 2013 Annual Report on Form 10-K. These filings are available publicly on the SEC's web site at <http://www.sec.gov>, on the Corporation's web site at <http://www.chemungcanal.com> or upon request from the Corporate Secretary at (607) 737-3746. Except as otherwise required by law, the Corporation undertakes no obligation to publicly update or revise its forward-looking statements, whether as a result of new information, future events, or otherwise.

Use of Non-GAAP Financial Measures

The SEC has adopted Regulation G, which applies to all public disclosures, including earnings releases, made by registered companies that contain "non-GAAP financial measures." Under Regulation G, companies making public disclosures containing non-GAAP financial measures must also disclose, along with each non-GAAP financial measure, certain additional information, including a reconciliation of the non-GAAP financial measure to the closest comparable GAAP financial measure and a statement of the Corporation's reasons for utilizing the non-GAAP financial measure as part of its financial disclosures. The SEC has exempted from the definition of "non-GAAP financial measures" certain commonly used financial measures that are not based on GAAP. When these exempted measures are included in public disclosures, supplemental information is not required. The following measures used in this Report, which are commonly utilized by financial institutions, have not been specifically exempted by the SEC and may constitute "non-GAAP financial measures" within the meaning of the SEC's new rules, although we are unable to state with certainty that the SEC would so regard them.

Tax-Equivalent Net Interest Income and Net Interest Margin

Net interest income is commonly presented on a tax-equivalent basis. That is, to the extent that some component of the institution's net interest income, which is presented on a before-tax basis, is exempt from taxation (e.g., is received by the institution as a result of its holdings of state or municipal obligations), an amount equal to the tax benefit derived from that component is added to the actual before-tax net interest income total. This adjustment is considered helpful in comparing one financial institution's net interest income to that of other institutions or in analyzing any institution's net interest income trend line over time, to correct any analytical distortion that might otherwise arise from the fact that financial institutions vary widely in the proportions of their portfolios that are invested in tax-exempt securities, and that even a single institution may significantly alter over time the proportion of its own portfolio that is invested in tax-exempt obligations. Moreover, net interest income is itself a component of a second financial measure commonly used by financial institutions, net interest margin, which is the ratio of net interest income to average interest-earning assets. For purposes of this measure as well, fully taxable equivalent net interest income is generally used by financial institutions, as opposed to actual net interest income, again to provide a better basis of comparison from institution to institution and to better demonstrate a single institution's performance over time. The Corporation follows these practices.

Tangible Book Value per Share

Tangible equity is total shareholders' equity less intangible assets. Tangible book value per share is tangible equity divided by total shares issued and outstanding. Tangible book value per share is often regarded as a more meaningful comparative ratio than book value per share as calculated under GAAP, that is, total shareholders' equity including intangible assets divided by total shares issued and outstanding. Intangible assets include goodwill and other intangible assets resulting from business combinations.

Adjustments for Certain Items of Income or Expense

In addition to disclosures of certain GAAP financial measures, including net income, basic and diluted earnings per share ("EPS"), return on average assets ("ROA"), and return on average equity ("ROE"), we may also provide comparative disclosures that adjust these GAAP financial measures for a particular period by removing from the calculation thereof the impact of certain transactions or other material items of income or expense occurring during the period, including certain nonrecurring items. The Corporation believes that the resulting non-GAAP financial measures may improve an understanding of its results of operations by separating out any such transactions or items that may have had a disproportionate positive or negative impact on the Corporation's financial results during the particular period in question. In the Corporation's presentation of any such non-GAAP (adjusted) financial measures not specifically discussed in the preceding paragraphs, the Corporation supplies the supplemental financial

information and explanations required under Regulation G.

The Corporation believes that the non-GAAP financial measures disclosed by it from time-to-time are useful in evaluating the Corporation's performance and that such information should be considered as supplemental in nature and not as a substitute for or superior to the related financial information prepared in accordance with GAAP. The Corporation's non-GAAP financial measures may differ from similar measures presented by other companies.

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Overview

The Corporation is a bank holding company and a financial holding company registered with the FRB. The Bank is a New York chartered commercial bank established in 1833 and is a wholly owned subsidiary of the Corporation. Through the Bank and CFS Group, Inc., its wholly owned financial services subsidiary, the Corporation provides a wide range of services, including demand, savings and time deposits; commercial, residential and consumer loans and letters of credit; wealth management services, employee benefit plans and securities and insurance brokerage services. The Bank relies substantially on a foundation of locally generated deposits.

The Corporation does not engage in any material operations apart from its ownership of the Bank and CFS Group, Inc. The Bank derives its income primarily from interest and fees on loans, interest on investment securities, Wealth Management Group fee income and fees received in connection with deposit and other services. The Bank's operating expenses are interest expense paid on deposits and borrowings, salaries and employee benefit plans and general operating expenses.

Three and Nine Months Ended September 30, 2014 Highlights

The Bank is a party to two legal proceedings involving its Wealth Management Group. For both legal proceedings, the Bank agreed to participate in non-binding mediation which began November 10, 2014. As a result of mediation and in anticipation of a formal agreement with both parties, the Bank's Board of Directors approved the establishment of an accrual for legal settlement in the amount of \$4.3 million as of September 30, 2014. The accrual for legal settlement was recorded as an expense in the quarter ended September 30, 2014, with a related tax benefit of \$1.7 million.

The Corporation's October 23, 2014 earnings release did not reflect the accrual for legal settlement, as the Corporation was unable to reasonably estimate a potential loss relating to the two legal proceedings at that point in time. The accrual for legal settlement changed the previously reported 2014 year-to-date amounts for net income of \$6.3 million to \$3.7 million, income tax expense of \$2.9 million to \$1.2 million, non-interest expense of \$40.4 million to \$44.7 million and basic and diluted earnings per share of \$1.34 to \$0.79. In addition, total shareholders' equity decreased from \$142.1 million to \$139.6 million, while total assets increased from \$1.522 billion to \$1.524 billion.

The net loss for the third quarter of 2014 was \$0.3 million, or \$(0.07) per share, compared with net income of \$2.2 million, or \$0.47 per share, for the same quarter in the prior year. Net income for the nine months ended September 30, 2014 was \$3.7 million, or \$0.79 per share, compared with \$7.2 million, or \$1.56 per share for the same period in the prior year.

Net interest margin (fully taxable equivalent) for the third quarter of 2014 was 3.56%, compared with 3.51% for the preceding quarter and 3.90% for the same quarter in the prior year. Net interest margin (fully taxable equivalent) for the nine months ended September 30, 2014 was 3.55%, down from 3.99% for the same period in the prior year.

Average interest-earning assets increased \$218.5 million year-over-year as a result of organic loan growth and the fourth quarter 2013 branch acquisition.

Total loans increased \$118.3 million, or 11.9%, from \$995.9 million at December 31, 2013 to \$1.114 billion at September 30, 2014. This increase was attributable to growth of \$82.5 million, or 15.9%, in commercial loans and \$38.9 million, or 13.8%, in consumer loans, due primarily to indirect consumer loans.

Non-performing assets to total assets ratio was 0.68% at September 30, 2014 compared with 0.61% at December 31, 2013 and 0.61% at September 30, 2013.

Book value per share was \$29.78 at September 30, 2014 compared with \$29.67 at December 31, 2013, an increase of \$0.11, or 0.4%, and \$28.93 at September 30, 2013, an increase of \$0.85, or 2.9%. Tangible book value per share was \$23.98 at September 30, 2014 compared with \$23.63 at December 31, 2013, an increase of \$0.35, or 1.5%, and \$23.28 at September 30, 2013, an increase of \$0.70, or 3.0%.

Dividends declared during the quarter ended September 30, 2014 were \$0.26 per share, level with the prior year.

Critical Accounting Policies, Estimates and Risks and Uncertainties

Critical accounting policies include the areas where the Corporation has made what it considers to be particularly difficult, subjective or complex judgments concerning estimates, and where these estimates can significantly affect the Corporation's financial results under different assumptions and conditions. The Corporation prepares its financial statements in conformity with GAAP. As a result, the Corporation is required to make certain estimates, judgments and assumptions that it believes are reasonable based upon the information available at that time. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods presented. Actual results could be different from these estimates.

Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the uncertainty in evaluating the level of the allowance required to cover probable incurred credit losses inherent in the loan portfolio, and the material effect that such judgments can have on the Corporation's results of operations. While management's current evaluation of the allowance for loan losses indicates that the allowance is adequate, under adversely different conditions or assumptions the allowance would need to be increased. For example, if historical loan loss experience significantly worsened or if current economic conditions significantly deteriorated, additional provisions for loan losses would be required to increase the allowance. In addition, the assumptions and estimates used in the internal reviews of the Corporation's non-performing loans and potential problem loans, and the associated evaluation of the related collateral coverage for these loans, has a significant impact on the overall analysis of the adequacy of the allowance for loan losses. Real estate values in the Corporation's market area did not increase dramatically in the prior several years, and, as a result, any declines in real estate values have been modest. While management has concluded that the current evaluation of collateral values is reasonable under the circumstances, if collateral evaluations were significantly lowered, the Corporation's allowance for loan losses policy would also require additional provisions for loan losses.

Management also considers the accounting policy relating to the valuation of goodwill and other intangible assets to be a critical accounting policy. The initial carrying value of goodwill and other intangible assets is determined using estimated fair values developed from various sources and other generally accepted valuation techniques. Estimates are based upon financial, economic, market and other conditions as they existed as of the date of a particular acquisition. These estimates of fair value are the results of judgments made by the Corporation based upon estimates that are inherently uncertain and changes in the assumptions upon which the estimates were based may have a significant impact on the resulting estimates. In addition to the initial determination of the carrying value, on an ongoing basis management must assess whether there is any impairment of goodwill and other intangible assets that would require an adjustment in carrying value and recognition of a loss in the consolidated statement of income.

Financial Condition

Consolidated assets at September 30, 2014 totaled \$1.524 billion, an increase of \$47.4 million, or 3.2%, since December 31, 2013. The growth was due primarily to increases of \$118.3 million, or 11.9%, in total portfolio loans, partially offset by decreases of \$59.1 million in investment securities and \$16.6 million in cash and cash equivalents. The increase in portfolio loans was due to strong growth of \$82.5 million in commercial loans and \$38.9 million in consumer loans. The proceeds from the sales and calls of securities and the decrease in cash and cash equivalents were used to fund the growth in the loan portfolio.

Total liabilities increased \$46.4 million to \$1.384 billion at September 30, 2014, due primarily to an increase of \$44.7 million in deposits. The increase in deposits was due in part to the seasonal inflow of public deposits.

Total shareholders' equity was \$139.6 million at September 30, 2014, an increase of \$1.0 million from December 31, 2013, due primarily to the Corporation's net income of \$3.7 million, an increase of \$0.3 million in accumulated other comprehensive income and a reduction of \$0.4 million in treasury stock. These items were partially offset by declared dividends of \$3.6 million. The reduction in treasury stock was due to the issuance of common shares for the Board of Director's Stock Compensation Plan and the Corporation's Restricted Stock Plan.

The market value of total assets under management or administration in the Corporation's Wealth Management Group was \$1.910 billion at September 30, 2014 compared with \$1.888 billion at December 31, 2013.

Cash and Cash Equivalents

Total cash and cash equivalents decreased since December 31, 2013, due primarily to a decrease of \$16.9 million in interest-bearing deposits in other financial institutions. As stated above, the decrease was used to help fund the growth in the loan portfolio. The Corporation continues to evaluate alternative investment of these funds with caution, given the current low interest rate environment.

Securities

The Corporation's Funds Management Policy includes an investment policy that in general, requires debt securities purchased for the bond portfolio to carry a minimum agency rating of "A". After an independent credit analysis is performed, the policy also allows the Corporation to purchase local municipal obligations that are not rated. The Corporation intends to maintain a reasonable level of securities to provide adequate liquidity and in order to have securities available to pledge to secure public deposits, repurchase agreements and other types of transactions. Fluctuations in the fair value of the Corporation's securities relate primarily to changes in interest rates.

Marketable securities are classified as Available for Sale, while investments in local municipal obligations are generally classified as Held to Maturity. The composition of the available for sale segment of the securities portfolio is summarized in Table 1 as follows (in thousands of dollars):

| | September 30, 2014 | | | December 31, 2013 | | |
|--|--------------------|----------------------|---------------------------|-------------------|----------------------|---------------------------|
| | Amortized Cost | Estimated Fair Value | Unrealized Gains (Losses) | Amortized Cost | Estimated Fair Value | Unrealized Gains (Losses) |
| Securities Available for Sale | | | | | | |
| Obligations of U.S. Government and U.S. Government sponsored enterprises | \$175,960 | \$177,215 | \$ 1,255 | \$187,098 | \$188,106 | \$ 1,008 |
| Mortgage-backed securities, residential | 63,858 | 64,571 | 713 | 104,069 | 104,356 | 287 |
| Collateralized mortgage obligations | 457 | 464 | 7 | 1,001 | 1,015 | 14 |
| Obligations of states and political subdivisions | 32,710 | 33,680 | 970 | 37,339 | 38,376 | 1,037 |
| Corporate bonds and notes | 1,505 | 1,539 | 34 | 2,879 | 2,946 | 67 |
| SBA loan pools | 1,340 | 1,349 | 9 | 1,471 | 1,488 | 17 |
| Trust preferred securities | 1,904 | 2,025 | 121 | 1,898 | 2,034 | 136 |
| Corporate stocks | 433 | 7,254 | 6,821 | 444 | 7,695 | 7,251 |
| Totals | \$278,167 | \$288,097 | \$ 9,930 | \$336,199 | \$346,016 | \$ 9,817 |

The available for sale segment of the securities portfolio totaled \$288.1 million at September 30, 2014, a decrease of \$57.9 million, or 16.7%, from \$346.0 million at December 31, 2013. The decrease resulted primarily from sales and calls of \$55.6 million, and maturities and principal collected of \$19.4 million, partially offset by purchases of \$18.3 million. The proceeds from the sales and calls of securities were used to help fund the growth in the loan portfolio.

The held to maturity segment of the securities portfolio consists of obligations of political subdivisions in the Corporation's market areas. These securities totaled \$5.4 million at September 30, 2014, a net decrease of \$1.1 million due primarily to maturities and principal collected of \$3.0 million, partially offset by purchases of \$2.0 million.

Loans

The Corporation has reporting systems to monitor: (i) loan origination and concentrations, (ii) delinquent loans, (iii) non-performing assets, including non-performing loans, troubled debt restructurings and other real estate owned, (iv) impaired loans, and (v) potential problem loans. Management reviews these systems on a regular basis.

Table 2 shows the Corporation's loan composition by segment for the periods indicated, and the dollar and percent change from December 31, 2013 to September 30, 2014 (in thousands of dollars):

TABLE 2. LOANS

| | September 30, 2014 | December 31, 2013 | Dollar Change | Percent Change |
|-----------------------------|-----------------------|----------------------|------------------|-------------------|
| Commercial and agricultural | \$165,852 | \$145,363 | \$20,489 | 14.1 % |
| Commercial mortgages | 435,166 | 373,147 | 62,019 | 16.6 % |
| Residential mortgages | 192,870 | 195,997 | (3,127) | -1.6 % |
| Indirect consumer loans | 196,603 | 164,846 | 31,757 | 19.3 % |
| Consumer loans | 123,691 | 116,513 | 7,178 | 6.2 % |
| Loans, net | \$1,114,182 | \$995,866 | \$118,316 | 11.9 % |

Portfolio loans totaled \$1.114 billion at September 30, 2014, an increase of \$118.3 million, or 11.9%, from \$995.9 million at December 31, 2013. The increase in portfolio loans was due to strong growth of \$62.0 million, or 16.6%, in commercial mortgages and \$31.8 million, or 19.3%, in indirect consumer loans. The growth in commercial mortgages was due primarily to loans originated by the Capital Bank division in the Albany, New York region. The growth in indirect consumer loans was a result of the Corporation's plan to extend into 2014 its loan program with reduced pricing on high quality indirect auto loans.

Residential mortgage loans totaled \$192.8 million at September 30, 2014, a decrease of \$3.1 million, or 1.6%, from December 31, 2013. In addition, during the nine months ended September 30, 2014, \$9.1 million of newly originated residential mortgages were sold in the secondary market to Freddie Mac and \$0.1 million in residential mortgages were sold to the State of New York Mortgage Agency. During the twelve months ended December 31, 2013, \$18.8 million of residential mortgages were sold in the secondary market to Freddie Mac, with an additional \$0.7 million of residential mortgages sold to the State of New York Mortgage Agency.

The Corporation anticipates that future growth in portfolio loans will continue to be in commercial mortgages, commercial and industrial loans and indirect consumer loans.

Non-Performing Assets

Non-performing assets consist of non-accrual loans, non-accrual troubled debt restructurings and other real estate owned that has been acquired in partial or full satisfaction of loan obligations or upon foreclosure.

Past due status on all loans is based on the contractual terms of the loan. It is generally the Corporation's policy that a loan 90 days past due be placed in non-accrual status unless factors exist that would eliminate the need to place a loan in this status. A loan may also be designated as non-accrual at any time if payment of principal or interest in full is not expected due to deterioration in the financial condition of the borrower. At the time loans are placed in non-accrual status, the accrual of interest is discontinued and previously accrued interest is reversed. All payments received on non-accrual loans are applied to principal. Loans are considered for return to accrual status when they become current as to principal and interest and remain current for a period of six consecutive months or when, in the opinion of management, the Corporation expects to receive all of its contractual principal and interest. In the case of non-accrual loans where a portion of the loan has been charged off, the remaining balance is kept in non-accrual status until the entire principal balance has been recovered.

Table 3 summarizes the Corporation's non-performing assets, excluding acquired PCI loans (in thousands of dollars):

| | September 30, 2014 | December 31, 2013 | | |
|--|-----------------------|----------------------|----------|----------|
| Non-accrual loans | \$ 6,599 | \$ 7,456 | | |
| Non-accrual troubled debt restructurings | 610 | 1,061 | | |
| Total non-performing loans | \$ 7,209 | \$ 8,517 | | |
| Other real estate owned | 3,119 | 538 | | |
| Total non-performing assets | \$ 10,328 | \$ 9,055 | | |
| Ratio of non-performing loans to total loans | | | 0.65 % | 0.86 % |
| Ratio of non-performing assets to total assets | | | 0.68 % | 0.61 % |
| Ratio of allowance for loan losses to non-performing loans | | | 182.42 % | 150.01 % |

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| | | |
|---|---------|---------|
| Accruing loans past due 90 days or more (1) | \$2,527 | \$1,473 |
| Accruing troubled debt restructurings (1) | \$8,108 | \$6,831 |

(1) These loans are not included in non-performing assets above.

Non-Performing Loans

Non-performing loans consist of non-accrual loans and non-accrual troubled debt restructurings.

The recorded investment in non-performing loans at September 30, 2014 totaled \$7.2 million compared to \$8.5 million at December 31, 2013, a decrease of \$1.3 million. The decrease in non-performing loans was due primarily to decreases of \$1.0 million in non-accrual commercial and industrial loans and \$0.2 million in non-accrual residential mortgages.

The recorded investment in accruing loans past due 90 days or more totaled \$2.5 million at September 30, 2014, up from \$1.5 million at December 31, 2013. The increase in accruing loans past due 90 days or more was in commercial mortgages.

Not included in non-performing loan totals are \$5.8 million of acquired loans which the Corporation has identified as PCI loans. The PCI loans are accounted for under separate accounting guidance, Accounting Standards Codification ("ASC") Subtopic 310-30, "Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality" as disclosed in Note 4 of the financial statements.

Troubled Debt Restructurings

The Corporation works closely with borrowers that have financial difficulties to identify viable solutions that minimize the potential for loss. In that regard, the Corporation modified the terms of select loans to maximize their collectability. These modifications may be considered TDRs under current accounting guidance. The Corporation offers various types of modifications which may involve a change in the schedule of payments, a reduction in the interest rate, an extension of the maturity date, 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, substituting or adding a new borrower or guarantor, a permanent reduction of the recorded investment in the loan or a permanent reduction of the interest on the loan. As of September 30, 2014, the Corporation had \$0.6 million of non-accrual TDRs compared with \$1.1 million as of December 31, 2013. As of September 30, 2014, the Corporation had \$8.1 million of accruing TDRs compared with \$6.8 million as of December 31, 2013. The increase in total TDRs was primarily in the commercial loan segment of the loan portfolio.

Impaired Loans

A loan is classified as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect both the principal and interest due under the contractual terms of the loan agreement. Impaired loans at September 30, 2014 totaled \$14.0 million, including TDRs of \$8.7 million, compared to \$13.9 million at December 31, 2013, including TDRs of \$7.9 million. Not included in the impaired loan totals are acquired loans which the Corporation has identified as PCI loans, as these loans are accounted for under ASC Subtopic 310-30 as noted under the above discussion of non-performing loans. Included in the impaired loan total at September 30, 2014, are loans totaling \$1.4 million for which impairment allowances of \$0.3 million have been specifically allocated to the allowance for loan losses. As of December 31, 2013, the impaired loan total included \$2.0 million of loans for which specific impairment allowances of \$1.0 million were allocated to the allowance for loan losses. The decrease in the amount of impaired loans for which specific allowances were allocated to the allowance for loan losses was due primarily to a decrease of \$1.0 million in impaired commercial and industrial loans, partially offset by an increase in of \$0.3 million in impaired commercial mortgages.

The majority of the Corporation's impaired loans are secured and measured for impairment based on collateral evaluations. It is the Corporation's policy to obtain updated appraisals, by independent third parties, on loans secured by real estate at the time a loan is determined to be impaired. An impairment measurement is performed based upon the most recent appraisal on file to determine the amount of any specific allocation or charge-off. In determining the amount of any specific allocation or charge-off, the Corporation will make adjustments to reflect the estimated costs to sell the property. Upon receipt and review of the updated appraisal, an additional measurement is performed to determine if any adjustments are necessary to reflect the proper provisioning or charge-off. Impaired loans are reviewed on a quarterly basis to determine if any changes in credit quality or market conditions would require any additional allocation or recognition of additional charge-offs. Real estate values in the Corporation's market area have been holding steady. Non-real estate collateral may be valued using (i) an appraisal, (ii) net book value of the collateral per the borrower's financial statements, or (iii) accounts receivable aging reports, that may be adjusted based on management's knowledge of the client and client's business. If market conditions warrant, future appraisals are obtained for both real estate and non-real estate collateral.

Allowance for Loan Losses

The allowance is an amount that management believes will be adequate to absorb probable incurred losses on existing loans. The allowance is established based on management's evaluation of the probable incurred losses in our portfolio in accordance with GAAP, and is comprised of both specific valuation allowances and general valuation allowances.

Specific valuation allowances are established based on management's analyses of individually impaired loans. Factors considered by management in determining impairment include payment status, evaluations of the underlying collateral, expected cash flows, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the 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 reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is determined to be impaired and is placed on nonaccrual status, all future payments received are applied to principal and a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

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The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. Loans not impaired but classified as substandard and special mention use a historical loss factor on a rolling five year history of net losses. For all other unclassified loans, the historical loss experience is determined by portfolio class and is based on the actual loss history experienced by the Corporation over the most recent two years. This actual loss experience is supplemented with other qualitative factors based on the risks present for each portfolio class. These qualitative factors include consideration of the following: (1) lending policies and procedures, including underwriting standards and collection, charge-off and recovery policies, (2) national and local economic and business conditions and developments, including the condition of various market segments, (3) loan profiles and volume of the portfolio, (4) the experience, ability, and depth of lending management and staff, (5) the volume and severity of past due, classified and watch-list loans, non-accrual loans, troubled debt restructurings, and other modifications (6) the quality of the Bank's loan review system and the degree of oversight by the Bank's Board of Directors, (7) collateral related issues: secured vs. unsecured, type, declining valuation environment and trend of other related factors, (8) the existence and effect of any concentrations of credit, and changes in the level of such concentrations, (9) the effect of external factors, such as competition and legal and regulatory requirements, on the level of estimated credit losses in the Bank's current portfolio and (10) the impact of the global economy.

The allowance for loan losses is increased through a provision for loan losses charged to operations. Loans are charged against the allowance for loan losses when management believes that the collectability of all or a portion of the principal is unlikely. Management's evaluation of the adequacy of the allowance for loan losses is performed on a periodic basis and takes into consideration such factors as the credit risk grade assigned to the loan, historical loan loss experience and review of specific impaired loans. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

The allowance for loan losses was \$13.2 million at September 30, 2014, up from \$12.8 million at December 31, 2013. The ratio of allowance for loan losses to total loans was 1.18% at September 30, 2014, compared with 1.28% at December 31, 2013. The increase in the allowance for loan losses was due primarily to loan portfolio growth. Net charge-offs for the nine months ended September 30, 2014 were \$1.1 million compared with net recoveries of \$0.3 million for the prior year. The increase in net charge-offs was primarily in the commercial loan portfolio, along with a slight increase in the consumer loan portfolio.

Table 4 summarizes the Corporation's loan loss experience for the nine months ended September 30, 2014 and 2013 (in thousands of dollars, except ratio data):

TABLE 4. SUMMARY OF LOAN LOSS EXPERIENCE

| | Nine Months Ended | |
|--------------------------------|-------------------|-----------|
| | September | |
| | 30, | September |
| | 2014 | 30, 2013 |
| Balance at beginning of period | \$ 12,776 | \$ 10,433 |
| Charge-offs: | | |
| Commercial and agricultural | 415 | 186 |
| Commercial mortgages | 1,236 | 44 |
| Residential mortgages | 97 | 53 |
| Consumer loans | 1,191 | 910 |
| Total charge-offs | 2,939 | 1,193 |

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Recoveries:

| | | | | |
|---|----------|---|-----------|---|
| Commercial and agricultural | 331 | | 454 | |
| Commercial mortgages | 118 | | 53 | |
| Residential mortgages | 28 | | 65 | |
| Consumer loans | 507 | | 289 | |
| Total recoveries | 984 | | 861 | |
| Net charge-offs (recoveries) | 1,955 | | 332 | |
| Provision charged to operations | 2,330 | | 1,755 | |
| Balance at end of period | \$13,151 | | \$ 11,856 | |
| Ratio of net charge-offs to average loans outstanding | 0.25 | % | 0.05 | % |
| Ratio of allowance for loan losses to total loans outstanding | 1.18 | % | 1.23 | % |

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Deposits

Table 5 shows the Corporation's deposit composition by segment for the periods indicated, and the dollar and percent change from December 31, 2013 to September 30, 2014 (in thousands of dollars):

| | September 30, 2014 | December 31, 2013 | Dollar Change | Percent Change |
|--------------------------------------|-----------------------|----------------------|------------------|-------------------|
| Non-interest-bearing demand deposits | \$372,916 | \$351,222 | \$21,694 | 6.2 % |
| Interest-bearing demand deposits | 138,751 | 114,679 | 24,072 | 21.0 % |
| Insured money market accounts | 391,671 | 361,095 | 30,576 | 8.5 % |
| Savings deposits | 196,406 | 194,768 | 1,638 | 0.8 % |
| Time deposits | 211,255 | 244,492 | (33,237) | -13.6 % |
| Total | \$1,310,999 | \$1,266,256 | \$44,743 | 3.5 % |

Deposits totaled \$1.311 billion at September 30, 2014, compared with \$1.266 billion at December 31, 2013, an increase of \$44.7 million, or 3.5%. The increase was due primarily to the increase of \$30.6 million in money market accounts, due in part to the seasonal inflow of municipal deposits, \$21.7 million in non-interest bearing demand deposits, \$24.1 million in interest-bearing demand deposits and \$1.6 million in saving accounts. These items were partially offset by a decrease of \$33.2 million in time deposits.

In addition to consumer, commercial and public deposits, other sources of funds include brokered deposits. Brokered deposits include funds obtained through brokers, and the Bank's participation in the Certificate of Deposit Account Registry Service ("CDARS") and Insured Cash Sweep Service ("ICS") programs. The CDARS and ICS programs involve a network of financial institutions that exchange funds among members in order to ensure FDIC insurance coverage on customer deposits above the single institution limit. Using a sophisticated matching system, funds are exchanged on a dollar-for-dollar basis, so that the equivalent of an original deposit comes back to the originating institution. Deposits obtained through brokers were \$2.5 million at September 30, 2014 compared with \$5.0 million as of December 31, 2013. Deposits obtained through the CDARS and ICS programs were \$74.6 million at September 30, 2014 compared with \$35.7 million as of December 31, 2013. The increase in CDARS and ICS deposits was due to the Corporation offering the programs to local municipalities.

The Corporation's deposit strategy is to fund the Bank with stable, low-cost deposits, primarily checking account deposits and other low interest-bearing deposit accounts. A checking account is the driver of a banking relationship and consumers consider the bank where they have their checking account as their primary bank. These customers will typically turn to their primary bank first when in need of other financial services. Strategies that have been developed and implemented to generate these deposits include: (i) acquire deposits by entering new markets through de novo branching, (ii) an annual checking account marketing campaign, (iii) training branch employees to identify and meet client financial needs with Bank products and services, (iv) link business and consumer loans to primary checking account at the Bank, (v) aggressively promote direct deposit of client's payroll checks or benefit checks and (vi) constantly monitor the Corporation's pricing strategies to ensure competitive products and services.

The Corporation also considers brokered deposits to be an element of its deposit strategy and anticipates that it will continue using brokered deposits as a secondary source of funding to support growth.

Borrowings

FHLB term advances were \$24.1 million at September 30, 2014, a decrease of \$1.1 million from December 31, 2013. The decrease in FHLB term advances was due to scheduled repayments. Securities sold under agreements to

repurchase decreased \$1.7 million from \$32.7 million at December 31, 2013 to \$31.0 million at September 30, 2014. The decrease in securities sold under agreements to repurchase was related to normal fluctuations in client accounts.

Shareholders' Equity

Total shareholders' equity was \$139.6 million at September 30, 2014 compared with \$138.6 million at December 31, 2013. The increase was due primarily to the Corporation's net income of \$3.7 million, an increase of \$0.3 million in accumulated other comprehensive income and a reduction of \$0.4 million in treasury stock. These items were partially offset by declared dividends of \$3.6 million. The total shareholders' equity to total assets ratio was 9.16% at September 30, 2014 compared with 9.39% at December 31, 2013. The tangible equity to tangible assets ratio was 7.51% at September 30, 2014 compared with 7.62% at December 31, 2013. Book value per share increased to \$29.78 at September 30, 2014 from \$29.67 at December 31, 2013.

The Corporation and the Bank are subject to capital adequacy guidelines of the Federal Reserve which establish a framework for the classification of financial holding companies and financial institutions into five categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. As of September 30, 2014, both the Corporation's and the Bank's capital ratios were in excess of those required to be considered well-capitalized under regulatory capital guidelines.

Liquidity and Capital Resources

Liquidity management involves the ability to meet the cash flow requirements of deposit clients, borrowers, and the operating, investing and financing activities of the Corporation. The Corporation uses a variety of resources to meet its liquidity needs. These include short term investments, cash flow from lending and investing activities, core-deposit growth and non-core funding sources, such as time deposits of \$100,000 or more, securities sold under agreements to repurchase and other borrowings.

The Corporation is a member of the FHLBNY which allows it to access borrowings which enhance management's ability to satisfy future liquidity needs. Based on available collateral and current advances outstanding, the Corporation was eligible to borrow up to a total of \$108.3 million and \$73.1 million at September 30, 2014 and December 31, 2013, respectively. The Corporation also had a total of \$28.0 million of unsecured lines of credit with four different financial institutions, all of which was available at September 30, 2014 and December 31, 2013.

During the nine months ended September 30, 2014, cash and cash equivalents decreased \$16.6 million. The major sources of cash during the nine months ended September 30, 2014 included \$12.4 million provided by operating activities, \$78.1 million in proceeds from sales, maturities, calls and principal reductions on investment securities and \$44.7 million in deposit growth. These proceeds were used primarily to fund purchases of securities totaling \$20.3 million, a \$123.3 million net increase in loans and payment of cash dividends in the amount of \$3.6 million.

Results of Operations

Comparison of Nine Months Ended September 30, 2014 and 2013

Net Income

Net income for the nine months ended September 30, 2014 was \$3.7 million, a decrease of \$3.5 million, or 49.3%, compared with \$7.2 million for the nine months ended September 30, 2013. Earnings per share for the nine months ended September 30, 2014 was \$0.79 compared with \$1.56 for the nine months ended September 30, 2013. Return on average assets and return on average equity for the nine months ended September 30, 2014 were 0.33% and 3.46%, respectively, compared with 0.76% and 7.25%, respectively, for the same period in the prior year.

The decline in net income for the nine months ended September 30, 2014 was due primarily to increases of \$9.8 million in non-interest expense and \$0.6 million in the provision for loan losses. These items were partially offset by increases of \$1.9 million in net interest income and \$2.3 million in non-interest income, and a reduction of \$2.3 million in income taxes. A majority of the increase in non-interest expense was related to the \$4.3 million proposed legal settlement and operating expenses directly related to the branches acquired in the fourth quarter of 2013.

Net Interest Income

Net interest income, which is the difference between the income we receive on interest-earning assets, such as loans and securities and the interest we pay on interest-bearing liabilities, such as deposits and borrowings, is the largest contributor to the Corporation's earnings.

Net interest income for the nine months ended September 30, 2014 totaled \$36.5 million, an increase of \$1.9 million, or 5.7%, compared with \$34.6 million for the same period in the prior year. Fully taxable equivalent net interest margin was 3.55% for the nine months ended September 30, 2014 compared with 3.99% for the same period in the prior year. The increase in net interest income was due primarily to an increase of \$218.5 million in interest-earning assets related to the branch acquisition in the fourth quarter of 2013. The decline in net interest margin was due in part to a 52 basis point decrease in the yield on interest-earning assets, partially offset by a 12 basis point decline in the cost of funds and the increase in interest-earning assets. The decrease in yield on interest-earning assets was attributable to a 44 basis point decrease in yields on loans, a result of loans continuing to reprice at current historically low market rates and the investment of cash from the acquired branch offices into investment securities.

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Average Consolidated Balance Sheet and Interest Analysis

Table 6 sets forth certain information related to the Corporation's average consolidated balance sheets and its consolidated statements of income for the nine month periods ended September 30, 2014 and 2013. Table 6 also reflects the average yield on assets and average cost of liabilities for the nine month periods ended September 30, 2014 and 2013. For the purpose of the table below, non-accruing loans are included in the daily average loan amounts outstanding. Daily balances were used for average balance computations. Investment securities are stated at amortized cost. Tax equivalent adjustments have been made in calculating yields on obligations of states and political subdivisions, tax-free commercial loans and dividends on equity investments.

TABLE 6. AVERAGE BALANCES AND YIELDS

Distribution of Assets, Liabilities and Shareholders' Equity, Interest Rates and Interest Differential

| (in thousands of dollars) | Nine Months Ended September 30, 2014 | | | Nine Months Ended September 30, 2013 | | |
|--|---|----------|----------------|---|----------|----------------|
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Assets | | | | | | |
| Earning assets: | | | | | | |
| Loans | \$1,050,905 | \$34,682 | 4.41 % | \$929,906 | \$33,704 | 4.85 % |
| Taxable securities | 271,670 | 3,951 | 1.94 % | 193,016 | 3,178 | 2.20 % |
| Tax-exempt securities | 40,975 | 1,100 | 3.59 % | 43,101 | 1,232 | 3.82 % |
| Interest-bearing deposits | 31,847 | 59 | 0.25 % | 10,873 | 21 | 0.25 % |
| Total earning assets | 1,395,397 | 39,792 | 3.81 % | 1,176,896 | 38,135 | 4.33 % |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 26,522 | | | 23,291 | | |
| Premises and equipment, net | 29,838 | | | 25,144 | | |
| Other assets | 51,125 | | | 46,918 | | |
| Allowance for loan losses | (13,231) | | | (10,924) | | |
| AFS valuation allowance | 11,109 | | | 11,881 | | |
| Total | \$1,500,760 | | | \$1,273,206 | | |
| Liabilities and Shareholders' Equity | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | \$124,739 | 73 | 0.08 % | \$95,218 | 70 | 0.10 % |
| Savings and insured money market deposits | 582,883 | 730 | 0.17 % | 448,506 | 613 | 0.18 % |
| Time deposits | 229,519 | 747 | 0.43 % | 229,362 | 1,108 | 0.65 % |
| FHLB advances, securities sold under agreements to repurchase and other debt | 55,737 | 1,206 | 2.89 % | 61,690 | 1,239 | 2.69 % |
| Total interest-bearing liabilities | 992,878 | 2,756 | 0.37 % | 834,775 | 3,030 | 0.49 % |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 356,978 | | | 296,089 | | |
| Other liabilities | 8,790 | | | 8,628 | | |
| Total liabilities | 1,358,646 | | | 1,139,492 | | |
| Shareholders' equity | 142,114 | | | 133,714 | | |
| Total | \$1,500,760 | | | \$1,273,206 | | |
| Fully taxable equivalent net interest income | | 37,036 | | | 35,105 | |

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| | | |
|---|----------|----------|
| Net interest rate spread(1) | 3.44 % | 3.84 % |
| Net interest margin, fully taxable equivalent (2) | 3.55 % | 3.99 % |
| Taxable equivalent adjustment | 502 | 544 |
| Net interest income | \$36,534 | \$34,561 |

(1) Net interest rate spread is the difference in the yield received on earning assets less the rate paid on interest-bearing liabilities.

(2) Net interest margin is the ratio of fully taxable equivalent net interest income divided by average earning assets.

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Changes Due to Volume and Rate

Net interest income can be analyzed in terms of the impact of changes in rates and volumes. Table 7 illustrates the extent to which changes in interest rates and in the volume of average interest-earning assets and interest-bearing liabilities have affected the Corporation's interest income and interest expense during the nine month periods ended September 30, 2014 and 2013. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior rate); (ii) changes attributable to changes in rates (changes in rates multiplied by prior volume); and (iii) the net changes. Due to the numerous simultaneous volume and rate changes during the periods analyzed, it is not possible to precisely allocate changes between volume and rates. For purposes of this table, changes that are not due solely to volume or rate changes have been allocated to these categories based on the respective percentage changes in average volume and rate. In addition, average earning assets include non-accrual loans and taxable equivalent adjustments were made.

TABLE 7. RATE/VOLUME ANALYSIS OF NET INTEREST INCOME

| (in thousands of dollars) | Nine Months Ended September 30, 2014 vs. 2013 | | |
|--|---|------------------|----------------|
| | Total Change | Due to Volume | Due to Rate |
| Interest and dividends earned on: | | | |
| Loans | \$978 | \$4,153 | \$(3,175) |
| Taxable investment securities | 773 | 1,178 | (405) |
| Tax-exempt investment securities | (132) | (59) | (73) |
| Interest-bearing deposits | 38 | 38 | - |
| Total earning assets | \$1,657 | \$5,310 | \$(3,653) |
| Interest paid on: | | | |
| Interest-bearing demand deposits | | \$3 | \$19 |
| Savings and insured money market deposits | | 117 | 171 |
| Time deposits | | (361) | 1 |
| FHLB advances, securities sold under agreements to repurchase and other debt | | (33) | (124) |
| Total interest-bearing liabilities | | \$(274) | \$67 |
| Net interest income | | \$1,931 | \$5,243 |
| | | | \$(3,312) |

Provision for Loan Losses

The provision for loan losses for the nine months ended September 30, 2014 totaled \$2.3 million compared with \$1.8 million for the nine months ended September 30, 2013. The increase in the provision for loan losses was due primarily to an increase in net charge-offs and growth in the loan portfolio. Net charge-offs for the nine months ended September 30, 2014 were \$2.0 million compared with \$0.3 million for the same period in the prior year. The increase in net charge-offs from the prior year was due primarily to the charge-off of three commercial loans, the majority attributable to two acquired PCI loans.

Non-Interest Income

Non-interest income for the nine months ended September 30, 2014 totaled \$15.4 million, an increase of \$2.6 million, or 19.5%, compared with \$12.8 million for the same period in the prior year. The increase was due primarily to a \$0.5 million net gain on securities transactions, increases of \$0.6 million in service charges on deposit accounts attributable to branches acquired in the fourth quarter of 2013, \$0.4 million in Wealth Management fee income, and a gain of \$0.5 million from the liquidation of the Corporation's investment in a pool of trust preferred securities.

Non-Interest Expense

Non-interest expense for the nine months ended September 30, 2014 totaled \$44.7 million, an increase of \$9.8 million, or 27.9%, compared with \$34.9 million for the same period in the prior year. The increase was due primarily to a \$4.3 million proposed legal settlement and increases of \$1.5 million in salaries and wages, \$1.2 million in occupancy expense, \$0.9 million in data processing expense, \$0.5 million in furniture and equipment expense, \$0.3 million in amortization of intangible assets, and \$0.7 million in other non-interest expense related to various items. A portion of the increase in non-interest expense was due to operating expenses directly related to the branches acquired in the fourth quarter of 2013, along with annual merit increases in salaries and wages and upgrades for ATMs and software.

Income Taxes

Income tax expense for the nine months ended September 30, 2014 totaled \$1.2 million, a decrease of \$2.3 million, compared with \$3.5 million for the same period in the prior year. Income tax expense reflects an effective tax rate of 24.6% for the nine months ended September 30, 2014 compared with 32.4% for the same period in the prior year. The decrease in the effective tax rate was due primarily to lower pre-tax income and an increase in the relative percentage of tax exempt income to pre-tax income.

Comparison of Three Months Ended September 30, 2014 and 2013

Net Income

The net loss for the three months ended September 30, 2014 was \$0.3 million, a decrease of \$2.5 million, or 114.6%, compared with net income of \$2.2 million for the three months ended September 30, 2013. Loss per share for the three months ended September 30, 2014 was \$(0.07) compared with earnings per share of \$0.47 for the three months ended September 30, 2013. Return on average assets and return on average equity for the three months ended September 30, 2014 were (0.08)% and (0.89)%, respectively, compared with 0.67% and 6.45%, respectively, for the same period in the prior year.

Net Interest Income

Net interest income, which is the difference between the income we receive on interest-earning assets, such as loans and securities and the interest we pay on interest-bearing liabilities, such as deposits and borrowings, is the largest contributor to the Corporation's earnings.

Net interest income for the three months ended September 30, 2014 totaled \$12.4 million, an increase of \$0.9 million, or 7.9%, compared with \$11.5 million for the same period in the prior year. Fully taxable equivalent net interest margin was 3.56% for the three months ended September 30, 2014 compared with 3.90% for the same period in the prior year. The increase in net interest income was due primarily to an increase of \$214.5 million in interest-earning assets related to the branch acquisition in the fourth quarter of 2013. The decline in net interest margin was due in part to a 41 basis point decrease in the yield on interest-earning assets, partially offset by a 10 basis point decline in the cost of funds and the increase in interest-earning assets. The decrease in yield on interest-earning assets was attributable to a 37 basis point decrease in yields on loans, a result of loans continuing to reprice at current historically low market rates and the investment of cash from the acquired branch offices into investment securities.

Average Consolidated Balance Sheet and Interest Analysis

Table 8 sets forth certain information related to the Corporation's average consolidated balance sheets and its consolidated statements of income for the three month periods ended September 30, 2014 and 2013. Table 8 also reflects the average yield on assets and average cost of liabilities for the three month periods ended September 30, 2014 and 2013. For the purpose of the table below, non-accruing loans are included in the daily average loan amounts outstanding. Daily balances were used for average balance computations. Investment securities are stated at amortized cost. Tax equivalent adjustments have been made in calculating yields on obligations of states and political subdivisions, tax-free commercial loans and dividends on equity investments.

TABLE 8. AVERAGE BALANCES AND YIELDS

Distribution of Assets, Liabilities and Shareholders' Equity, Interest Rates and Interest Differential

| (in thousands of dollars) | Three Months Ended September 30, 2014 | | | Three Months Ended September 30, 2013 | | |
|--|--|----------|----------------|--|----------|----------------|
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Assets | | | | | | |
| Earning assets: | | | | | | |
| Loans | \$1,097,133 | \$12,004 | 4.34 % | \$950,657 | \$11,278 | 4.71 % |
| Taxable securities | 244,269 | 1,142 | 1.86 % | 195,337 | 1,021 | 2.07 % |
| Tax-exempt securities | 37,734 | 350 | 3.68 % | 39,470 | 377 | 3.79 % |
| Interest-bearing deposits | 25,029 | 16 | 0.25 % | 4,514 | 3 | 0.25 % |
| Total earning assets | 1,404,165 | 13,512 | 3.82 % | 1,189,978 | 12,679 | 4.23 % |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 26,766 | | | 23,512 | | |
| Premises and equipment, net | 30,160 | | | 25,006 | | |
| Other assets | 51,063 | | | 46,465 | | |
| Allowance for loan losses | (13,694) | | | (11,300) | | |
| AFS valuation allowance | 10,855 | | | 9,916 | | |
| Total | \$1,509,315 | | | \$1,283,577 | | |
| Liabilities and Shareholders' Equity | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | \$124,490 | 24 | 0.08 % | \$88,854 | 22 | 0.10 % |
| Savings and insured money market deposits | 589,022 | 256 | 0.17 % | 458,836 | 205 | 0.18 % |
| Time deposits | 218,748 | 231 | 0.42 % | 226,278 | 345 | 0.61 % |
| FHLB advances, securities sold under agreements to repurchase and other debt | 56,278 | 404 | 2.85 % | 66,889 | 420 | 2.50 % |
| Total interest-bearing liabilities | 988,538 | 915 | 0.37 % | 840,857 | 992 | 0.47 % |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 368,823 | | | 299,603 | | |
| Other liabilities | 9,010 | | | 9,162 | | |
| Total liabilities | 1,366,371 | | | 1,149,622 | | |
| Shareholders' equity | 142,944 | | | 133,955 | | |
| Total | \$1,509,315 | | | \$1,283,577 | | |
| Fully taxable equivalent net interest income | | 12,597 | | | 11,687 | |

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| | | |
|---|----------|----------|
| Net interest rate spread(1) | 3.45 % | 3.76 % |
| Net interest margin, fully taxable equivalent (2) | 3.56 % | 3.90 % |
| Taxable equivalent adjustment | 171 | 170 |
| Net interest income | \$12,426 | \$11,517 |

(1) Net interest rate spread is the difference in the yield received on earning assets less the rate paid on interest-bearing liabilities.

(2) Net interest margin is the ratio of fully taxable equivalent net interest income divided by average earning assets.

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Changes Due to Volume and Rate

Net interest income can be analyzed in terms of the impact of changes in rates and volumes. Table 9 illustrates the extent to which changes in interest rates and in the volume of average interest-earning assets and interest-bearing liabilities have affected the Corporation's interest income and interest expense during the three month periods ended September 30, 2014 and 2013. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior rate); (ii) changes attributable to changes in rates (changes in rates multiplied by prior volume); and (iii) the net changes. Due to the numerous simultaneous volume and rate changes during the periods analyzed, it is not possible to precisely allocate changes between volume and rates. For purposes of this table, changes that are not due solely to volume or rate changes have been allocated to these categories based on the respective percentage changes in average volume and rate. In addition, average earning assets include non-accrual loans and taxable equivalent adjustments were made.

TABLE 9. RATE/VOLUME ANALYSIS OF NET INTEREST INCOME

| (in thousands of dollars) | Three Months Ended September 30, 2014 vs. 2013 | | | |
|--|--|------------------|----------------|---------|
| | Increase/(Decrease) | | | |
| | Total Change | Due to Volume | Due to Rate | |
| Interest and dividends earned on: | | | | |
| Loans | \$726 | \$1,649 | \$(923) | |
| Taxable investment securities | 121 | 237 | (116) | |
| Tax-exempt investment securities | (27) | (17) | (10) | |
| Interest-bearing deposits | 13 | 13 | - | |
| Total earning assets | \$833 | \$1,882 | \$(1,049) | |
| Interest paid on: | | | | |
| Interest-bearing demand deposits | | \$2 | \$7 | \$(5) |
| Savings and insured money market deposits | | 51 | 57 | (6) |
| Time deposits | | (114) | (11) | (103) |
| FHLB advances, securities sold under agreements to repurchase and other debt | | (16) | (72) | 56 |
| Total interest-bearing liabilities | | \$(77) | \$(19) | \$(58) |
| Net interest income | | \$910 | \$1,901 | \$(991) |

Provision for Loan Losses

The provision for loan losses for the three months ended September 30, 2014 totaled \$0.6 million compared with \$0.9 million for the three months ended September 30, 2013. Net charge-offs for the current quarter were \$1.1 million compared with \$0.3 million for the same period in the prior year. The increase in net charge-offs was due primarily to a \$0.9 million charge-off of an acquired PCI loan that was transferred to other real estate owned.

Non-Interest Income

Non-interest income for the three months ended September 30, 2014 totaled \$5.0 million, an increase of \$0.6 million, or 14.6%, compared with \$4.4 million for the same period in the prior year. The increase was due primarily to

increases of \$0.2 million in check fee income, \$0.2 million in service charges on deposit accounts and \$0.1 million in Wealth Management fee income.

Non-Interest Expense

Non-interest expense for the three months ended September 30, 2014 totaled \$17.8 million, an increase of \$6.0 million, or 50.4%, compared with \$11.8 million for the same period in the prior year. The increase was due primarily to a \$4.3 million proposed legal settlement and increases of \$0.6 million in salaries and wages, \$0.4 million in occupancy expense, \$0.3 million in data processing expense and \$0.2 million in furniture and equipment expense. A portion of the increase in non-interest expense was due to operating expenses directly related to the branches acquired in the fourth quarter of 2013, along with annual merit increases in salaries and wages and upgrades for ATMs and software.

Income Taxes

An income tax benefit for the three months ended September 30, 2014 totaled \$0.6 million, compared with income tax expense of \$1.0 million for the same period in the prior year. The income tax benefit for the three months ended September 30, 2014 was related to the proposed legal settlement. Income tax expense reflects an effective tax rate of 31.5% for the three months ended September 30, 2013.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Management considers interest rate risk to be the most significant market risk for the Corporation. Market risk is the risk of loss from adverse changes in market prices and rates. Interest rate risk is the exposure to adverse changes in the net income of the Corporation as a result of changes in interest rates.

The Corporation's primary earnings source is net interest income, which is affected by changes in the level of interest rates, the relationship between rates, the impact of interest rate fluctuations on asset prepayments, the level and composition of deposits and liabilities, and credit quality of earning assets.

The Corporation's objectives in its asset and liability management are to maintain a strong, stable net interest margin, to utilize its capital effectively without taking undue risks, to maintain adequate liquidity, and to reduce vulnerability of its operations to changes in interest rates. The Corporation's Asset/Liability Committee ("ALCO") has the strategic responsibility for setting the policy guidelines on acceptable exposure to interest rate risk. These guidelines contain specific measures and limits regarding the risks, which are monitored on a regular basis. The ALCO is made up of the president and chief executive officer, the chief financial officer, the asset liability management officer, and other officers representing key functions.

Interest rate risk is the risk that net interest income will fluctuate as a result of a change in interest rates. It is the assumption of interest rate risk, along with credit risk, that drives the net interest margin of a financial institution. For that reason, the ALCO has established tolerance limits based upon a 200-basis point change in interest rates, with appropriate floors set for interest-bearing liabilities. At September 30, 2014, it is estimated that an immediate 200-basis point decrease in interest rates would negatively impact the next 12 months net interest income by 9.07% and an immediate 200-basis point increase would negatively impact the next 12 months net interest income by 9.02%. Both are within the Corporation's policy guideline of 15%. Given the overall low level of current interest rates and the unlikely event of a 200-basis point decline from this point, management additionally modeled an immediate 100-basis point decline and an immediate 300-basis point increase in interest rates. When applied, it is estimated these scenarios would result in negative impacts to net interest income of 3.96% and 13.45%, respectively.

A related component of interest rate risk is the expectation that the market value of the Corporation's capital account will fluctuate with changes in interest rates. This component is a direct corollary to the earnings-impact component: an institution exposed to earnings erosion is also exposed to shrinkage in market value. At September 30, 2014, it is estimated that an immediate 200-basis point decrease in interest rates would negatively impact the market value of the Corporation's capital account by 7.41% and an immediate 200-basis point increase in interest rates would negatively impact the market value by 3.71%. Both are within the Corporation's policy guideline of 15%. Management also modeled the impact to the market value of the Corporation's capital with an immediate 100-basis point decline and an immediate 300-basis point increase in interest rates, based on the current interest rate environment. When applied, it is estimated these scenarios would result in negative impacts to the market value of the Corporation's capital of 3.65% and 5.69%, respectively.

Management does recognize the need for certain hedging strategies during periods of anticipated higher fluctuations in interest rates and the Funds Management Policy provides for limited use of certain derivatives in asset liability management. These strategies were not employed during the nine months ended September 30, 2014.

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Credit Risk

The Corporation manages credit risk consistent with state and federal laws governing the making of loans through written policies and procedures; loan review to identify loan problems at the earliest possible time; collection procedures (continued even after a loan is charged off); an adequate allowance for loan losses; and continuing education and training to ensure lending expertise. Diversification by loan product is maintained through offering commercial loans, 1-4 family mortgages, and a full range of consumer loans.

The Corporation monitors its loan portfolio carefully. The Loan Committee of the Corporation's Board of Directors is designated to receive required loan reports, oversee loan policy, and approve loans above authorized individual and Senior Loan Committee lending limits. The Senior Loan Committee, consisting of the President and Chief Executive Officer, Chief Financial Officer (non-voting member) Chief Administrative and Risk Officer (non-voting member), business client division manager, retail client division manager, commercial loan manager, consumer loan manager, mortgage loan manager, and the President and commercial loan manager of the Capital Bank division, implements the Board-approved loan policy.

ITEM 4: CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Corporation's management, with the participation of our President and Chief Executive Officer, who is the Corporation's principal executive officer, and our Chief Financial Officer and Treasurer, who is the Corporation's principal financial officer, have evaluated the effectiveness of the Corporation's disclosure controls and procedures as of September 30, 2014 pursuant to Rule 13a-15 of the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the principal executive officer and principal financial officer have concluded that the Corporation's disclosure controls and procedures are not effective as a result of the material weakness that existed in the Corporation's internal control over financial reporting as previously described in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

Previously Identified Material Weakness

As of December 31, 2013 management concluded that its internal control over financial reporting was not effective because a material weakness existed in its internal control over the identification and evaluation of troubled debt restructurings. The process surrounding the identification of troubled debt restructurings is to include the completion of a checklist which guides the identification process for all loans modified, renewed or extended which meet certain credit grade and principal balance criteria. A key control to identify all loans which may be subject to a checklist has been implemented and will be tested for effectiveness during 2014.

In response to the material weakness, during the quarter ended March 31, 2014, the Corporation improved its process of identifying and evaluating trouble debt restructurings in order to remediate the material weakness. The Corporation has provided additional guidance and strengthened processes regarding the identification and evaluation of trouble debt restructurings, within our loan underwriting and credit administration functions, and provided additional training to our loan underwriting and credit administration staff. Additionally, the Corporation's internal audit personnel will be sampling and testing transactions related to troubled debt restructurings as a part of the Corporation's internal audit plan for 2014.

The remediation of the material weakness described above is ongoing. Management believes that its efforts, when fully implemented, will be effective in remediating the material weakness by the end of 2014. In addition,

management will continue to monitor the results of the remediation activities and test the new controls as part of its review of its internal control over financial reporting for 2014. Management remains committed to a strong internal control environment.

Except for the material weakness noted above, there have been no changes in the Corporation's internal control over financial reporting during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For information related to this item, please see Note 8 to the Corporation's financial statements included herein.

ITEM 1A. RISK FACTORS

There have been no material changes in the risk factors set forth in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission on March 14, 2014.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) Issuer Purchases of Equity Securities (1)

| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Maximum number of shares that may yet be purchased under the plans or programs |
|-----------------------|----------------------------------|------------------------------|--|--|
| 7/1/14-7/30/14 | - | \$ - | - | 121,906 |
| 8/1/14-8/31/14 | - | \$ - | - | 121,906 |
| 9/1/14-9/30/14 | - | \$ - | - | 121,906 |
| Quarter ended 9/30/14 | - | \$ - | - | 121,906 |

(1) On December 19, 2012, the Corporation's Board of Directors approved a stock repurchase plan authorizing the purchase of up to 125,000 shares of the Corporation's outstanding common stock. Purchases may be made from time to time on the open market or in private negotiated transactions and will be at the discretion of management. As of June 30, 2014, a total of 3,094 shares had been purchased under this plan.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

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ITEM 6. EXHIBITS

The following exhibits are either filed with this Form 10-Q or are incorporated herein by reference. The Corporation's Securities Exchange Act File number is 000-13888.

3.1 Certificate of Incorporation of Chemung Financial Corporation dated December 20, 1984. (Filed as Exhibit 3.1 to Registrant's Form 10-K filed with the SEC on March 13, 2008 and incorporated herein by reference).

3.2 Certificate of Amendment to the Certificate of Incorporation of Chemung Financial Corporation, dated March 28, 1988. (Filed as Exhibit 3.2 to Registrant's Form 10-K filed with the SEC on March 13, 2008 and incorporated herein by reference).

3.3 Certificate of Amendment to the Certificate of Incorporation of Chemung Financial Corporation, dated May 13, 1998. (Filed as Exhibit 3.4 of the Registrant's Form 10-K for the year ended December 31, 2005 and incorporated herein by reference).

3.4 Amended and Restated Bylaws of the Registrant, as amended to February 26, 2014. (Filed as Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed with the SEC on March 4, 2014 and incorporated herein by reference).

31.1 Certification of President and Chief Executive Officer of the Registrant pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.*

31.2 Certification of Chief Financial Officer and Treasurer of the Registrant pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.*

32.1 Certification of President and Chief Executive Officer of the Registrant pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. §1350.*

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101.INS Instance Document*

101.SCH XBRL Taxonomy Schema*

101.CAL XBRL Taxonomy Calculation Linkbase*

101.DEF XBRL Taxonomy Definition Linkbase*

101.LAB XBRL Taxonomy Label Linkbase*

101.PRE XBRL Taxonomy Presentation Linkbase*

* Filed herewith.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CHEMUNG FINANCIAL CORPORATION

DATED: November 17, 2014 By: /s/ Ronald M. Bentley
Ronald M. Bentley, President and Chief Executive Officer
(Principal Executive Officer)

DATED: November 17, 2014 By: /s/ Karl F. Krebs
Karl F. Krebs, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

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