ENB Financial Corp
Form 10-Q
November 13, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from ______________________________ to ______________________________

ENB Financial Corp

(Exact name of registrant as specified in its charter)

Pennsylvania	000-53297	51-0661129
(State or Other Jurisdiction of Incorporation)	(Commission File Number)	(IRS Employer Identification No)

31 E. Main St., Ephrata, PA 17522-0457

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (717) 733-4181

Former name, former address, and former fiscal year, if changed since last report Not Applicable

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 ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date 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 ý 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. (Check one):

Large Accelerated filer ¨ Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company ý

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

Yes ¨ No ý

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of November 3, 2014, the registrant had 2,857,415 shares of $0.20 (par) Common Stock outstanding.

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September 30, 2014

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CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	September 30, 2014 $	December 31, 2013 $	September 30, 2013 $
ASSETS			
Cash and due from banks	13,003	15,596	12,579
Interest-bearing deposits in other banks	31,076	8,981	17,753
Total cash and cash equivalents	44,079	24,577	30,332
Securities available for sale (at fair value)	301,297	300,328	280,705
Loans held for sale	257	59	308
Loans (net of unearned income)	457,873	438,220	435,916
Less: Allowance for loan losses	6,968	7,219	7,283
Net loans	450,905	431,001	428,633
Premises and equipment	22,693	23,012	22,305
Regulatory stock	4,184	3,660	3,415
Bank owned life insurance	20,406	19,911	19,719
Other assets	6,970	9,708	9,131
Total assets	850,791	812,256	794,548
LIABILITIES AND STOCKHOLDERS' EQUITY			
Liabilities:			
Deposits:			
Noninterest-bearing	188,391	173,070	165,874
Interest-bearing	498,953	483,556	476,877
Total deposits	687,344	656,626	642,751
Short-term borrowings	7,260	3,900	—
Long-term debt	62,300	65,000	65,000
Other liabilities	2,465	2,954	2,606
Total liabilities	759,369	728,480	710,357

Stockholders' equity:			
Common stock, par value $0.20;			
Shares: Authorized 12,000,000			
Issued 2,869,557 and Outstanding 2,857,415			
(Issued 2,869,557 and Outstanding 2,856,026 as of 12-31-13)			
(Issued 2,869,557 and Outstanding 2,852,097 as of 9-30-13)	574	574	574
Capital surplus	4,368	4,353	4,344
Retained earnings	86,169	83,165	81,767
Accumulated other comprehensive income (loss), net of tax	666	(3,940)	(2,009)
Less: Treasury stock cost on 12,142 shares (13,531 shares as of 12-31-13 and 17,460 shares as of 9-30-13)	(355)	(376)	(485)
Total stockholders' equity	91,422	83,776	84,191
Total liabilities and stockholders' equity	850,791	812,256	794,548

See Notes to the Unaudited Consolidated Interim Financial Statements

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CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	Three Months ended September 30,		Nine Months ended September 30,	
	2014	2013	2014	2013
	$	$	$	$
Interest and dividend income:				
Interest and fees on loans	4,848	4,766	14,444	14,224
Interest on securities available for sale				
Taxable	944	1,016	3,166	2,795
Tax-exempt	827	913	2,547	2,840
Interest on deposits at other banks	17	18	44	56
Dividend income	60	32	192	92
Total interest and dividend income	6,696	6,745	20,393	20,007
Interest expense:				
Interest on deposits	777	853	2,343	2,651
Interest on borrowings	378	469	1,246	1,449
Total interest expense	1,155	1,322	3,589	4,100
Net interest income	5,541	5,423	16,804	15,907
Credit for loan losses	—	—	(300)	(150)
Net interest income after credit for loan losses	5,541	5,423	17,104	16,057
Other income:				
Trust and investment services income	309	273	959	883
Service fees	507	461	1,321	1,300
Commissions	507	491	1,467	1,467
Gains on securities transactions, net	624	537	1,891	2,216
Impairment losses on securities:				
Impairment gains on investment securities	—	139	15	178
Non-credit related losses on securities not expected to be sold in other comprehensive income before tax	—	(183)	(37)	(335)
Net impairment losses on investment securities	—	(44)	(22)	(157)
Gains on sale of mortgages	120	20	250	208
Earnings on bank-owned life insurance	163	162	477	480
Other income	45	39	280	274
Total other income	2,275	1,939	6,623	6,671

Operating expenses:				
Salaries and employee benefits	3,517	3,193	10,428	9,545
Occupancy	476	462	1,451	1,303
Equipment	287	248	815	716
Advertising & marketing	95	68	350	307
Computer software & data processing	393	386	1,188	1,193
Shares tax	170	215	536	644
Professional services	311	297	991	925
Other expense	518	478	1,595	1,566
Total operating expenses	5,767	5,347	17,354	16,199
Income before income taxes	2,049	2,015	6,373	6,529
Provision for federal income taxes	337	274	1,083	958
Net income	1,712	1,741	5,290	5,571
Earnings per share of common stock	0.60	0.61	1.85	1.95
Cash dividends paid per share	0.27	0.26	0.80	0.78
Weighted average shares outstanding	2,857,225	2,851,695	2,855,417	2,851,863

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(DOLLARS IN THOUSANDS)

	Three Months ended September 30,		Nine Months ended September 30,	
	2014	2013	2014	2013
	$	$	$	$
Net income	1,712	1,741	5,290	5,571
Other comprehensive income (loss), net of tax:				
Net change in unrealized gains (losses):				
Other-than-temporarily impaired securities available for sale:				
Gains arising during the period	—	139	15	178
Income tax effect	—	(47)	(5)	(60)
	—	92	10	118
Losses recognized in earnings	—	44	22	157
Income tax effect	—	(15)	(7)	(54)
	—	29	15	103
Unrealized holding gains on other-than-temporarily impaired securities available for sale, net of tax	—	121	25	221
Securities available for sale not other-than-temporarily impaired:				
Gains (losses) arising during the period	1,919	(1,049)	8,833	(11,257)
Income tax effect	(652)	357	(3,004)	3,827
	1,267	(692)	5,829	(7,430)
Gains recognized in earnings	(624)	(537)	(1,891)	(2,216)
Income tax effect	212	182	643	753
	(412)	(355)	(1,248)	(1,463)
Unrealized holding gains (losses) on securities available for sale not other-than-temporarily impaired, net of tax	855	(1,047)	4,581	(8,893)
Other comprehensive income (loss), net of tax	855	(926)	4,606	(8,672)
Comprehensive Income (Loss)	2,567	815	9,896	(3,101)

See Notes to the Unaudited Consolidated Interim Financial Statements

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CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(DOLLARS IN THOUSANDS)

	Nine Months Ended September 30,	
	2014	2013
	$	$
Cash flows from operating activities:		
Net income	5,290	5,571
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of securities premiums and discounts and loan fees	3,726	3,086
Decrease in interest receivable	208	152
Decrease in interest payable	(100)	(101)
Credit for loan losses	(300)	(150)
Gains on securities transactions, net	(1,891)	(2,216)
Impairment losses on securities	22	157
Gains on sale of mortgages	(250)	(208)
Loans originated for sale	(8,867)	(10,276)
Proceeds from sales of loans	8,919	10,944
Earnings on bank-owned life insurance	(477)	(480)
Loss on sale of other real estate owned	23	—
Depreciation of premises and equipment and amortization of software	1,086	990
Deferred income tax	480	(171)
Decrease in prepaid federal deposit insurance	—	936
Other assets and other liabilities, net	(663)	(386)
Net cash provided by operating activities	7,206	7,848
Cash flows from investing activities:		
Securities available for sale:		
Proceeds from maturities, calls, and repayments	24,173	41,994
Proceeds from sales	99,348	76,427
Purchases	(119,273)	(107,602)
Purchase of other real estate owned	(56)	—
Proceeds from sale of other real estate owned	48	—
Purchase of regulatory bank stock	(890)	(230)
Redemptions of regulatory bank stock	366	963
Purchase of bank-owned life insurance	(18)	(23)
Net increase in loans	(19,699)	(21,695)
Purchases of premises and equipment	(691)	(2,333)
Purchase of computer software	(140)	(44)
Net cash used for investing activities	(16,832)	(12,543)
Cash flows from financing activities:		
Net increase in demand, NOW, and savings accounts	33,356	17,951
Net decrease in time deposits	(2,638)	(8,361)

Net increase in short-term borrowings	3,360	—
Proceeds from long-term debt	13,800	5,000
Repayments of long-term debt	(16,500)	(13,000)
Dividends paid	(2,286)	(2,225)
Treasury stock sold	374	359
Treasury stock purchased	(338)	(357)
Net cash provided by (used for) financing activities	29,128	(633)
Increase (decrease) in cash and cash equivalents	19,502	(5,328)
Cash and cash equivalents at beginning of period	24,577	35,660
Cash and cash equivalents at end of period	44,079	30,332
Supplemental disclosures of cash flow information:		
Interest paid	3,689	4,201
Income taxes paid	300	950
Supplemental disclosure of non-cash investing and financing activities:		
Net transfer of other real estate owned from loans	56	—
Fair value adjustments for securities available for sale	6,979	(13,138)

See Notes to the Unaudited Consolidated Interim Financial Statements

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ENB FINANCIAL CORP
Notes to the Unaudited Consolidated Interim Financial Statements

1. Basis of Presentation

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and to general practices within the banking industry. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all significant adjustments considered necessary for fair presentation have been included. Certain items previously reported have been reclassified to conform to the current period's reporting format. Such reclassifications did not affect net income or stockholders' equity.

ENB Financial Corp ("the Corporation") is the bank holding company for its wholly-owned subsidiary Ephrata National Bank (the "Bank"). This Form 10-Q, for the third quarter of 2014, is reporting on the results of operations and financial condition of ENB Financial Corp.

Operating results for the three and nine months ended September 30, 2014, are not necessarily indicative of the results that may be expected for the year ended December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in ENB Financial Corp's Annual Report on Form 10-K for the year ended December 31, 2013.

2. Securities Available for Sale

The amortized cost and fair value of securities held at September 30, 2014, and December 31, 2013, are as follows:

(DOLLARS IN THOUSANDS)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	$	$	$	$
September 30, 2014				
U.S. government agencies	37,702	30	(902)	36,830
U.S. agency mortgage-backed securities	46,485	438	(187)	46,736
U.S. agency collateralized mortgage obligations	59,309	149	(735)	58,723
Corporate bonds	53,053	174	(239)	52,988
Obligations of states and political subdivisions	98,363	2,723	(429)	100,657
Total debt securities	294,912	3,514	(2,492)	295,934

Marketable equity securities	5,376	6	(19)	5,363
Total securities available for sale	300,288	3,520	(2,511)	301,297
December 31, 2013				
U.S. government agencies	41,671	148	(2,152)	39,667
U.S. agency mortgage-backed securities	52,502	101	(680)	51,923
U.S. agency collateralized mortgage obligations	42,465	161	(938)	41,688
Private collateralized mortgage obligations	4,135	44	(138)	4,041
Corporate bonds	56,437	430	(673)	56,194
Obligations of states and political subdivisions	103,936	1,057	(3,349)	101,644
Total debt securities	301,146	1,941	(7,930)	295,157
Marketable equity securities	5,151	20	—	5,171
Total securities available for sale	306,297	1,961	(7,930)	300,328

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The amortized cost and fair value of debt securities available for sale at September 30, 2014, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities due to certain call or prepayment provisions.

CONTRACTUAL MATURITY OF DEBT SECURITIES
(DOLLARS IN THOUSANDS)

	Amortized Cost	Fair Value
	$	$
Due in one year or less	28,512	28,467
Due after one year through five years	102,658	102,407
Due after five years through ten years	74,412	73,867
Due after ten years	89,330	91,193
Total debt securities	294,912	295,934

Securities available for sale with a par value of $78,631,000 and $86,392,000 at September 30, 2014, and December 31, 2013, respectively, were pledged or restricted for public funds, borrowings, or other purposes as required by law. The fair value of these pledged securities was $81,577,000 at September 30, 2014, and $86,993,000 at December 31, 2013.

Proceeds from active sales of debt securities available for sale, along with the associated gross realized gains and gross realized losses, are shown below. Realized gains and losses are computed on the basis of specific identification.

PROCEEDS FROM SALES OF DEBT SECURITIES AVAILABLE FOR SALE
(DOLLARS IN THOUSANDS)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	$	$	$	$
Proceeds from sales	29,834	41,252	99,304	76,427
Gross realized gains	825	1,149	2,559	2,852
Gross realized losses	201	612	685	636

SUMMARY OF GAINS AND LOSSES ON DEBT
SECURITIES AVAILABLE FOR SALE
(DOLLARS IN THOUSANDS)

	Three Months	Nine Months Ended

	Ended September 30,		September 30,	
	2014	2013	2014	2013
	$	$	$	$
Gross realized gains	825	1,149	2,559	2,852
Gross realized losses	201	612	685	636
Impairment on securities	—	44	22	157
Total gross realized losses	201	656	707	793
Net gains on securities	624	493	1,852	2,059

The bottom portion of the above table shows the net gains on security transactions, including any impairment taken on securities held by the Corporation. The net gain or loss from security transactions is also reflected on the Corporation's Consolidated Statements of Income and Consolidated Statements of Cash Flows.

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Notes to the Unaudited Consolidated Interim Financial Statements

Management evaluates all of the Corporation's securities for other than temporary impairment (OTTI) on a periodic basis. Prior to June 30, 2014, the Corporation had a small number of private collateralized mortgage obligations (PCMOs) of which all but one had impairment recorded at some point in the past. During the second quarter of 2014, the three PCMOs remaining in the Corporation's securities portfolio were sold. No other securities in the portfolio had other-than-temporary impairment recorded in 2014.

Information pertaining to securities with gross unrealized losses at September 30, 2014, and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

TEMPORARY IMPAIRMENTS OF SECURITIES

(DOLLARS IN THOUSANDS)

	Less than 12 months		More than 12 months		Total	
	Fair Value $	Gross Unrealized Losses $	Fair Value $	Gross Unrealized Losses $	Fair Value $	Gross Unrealized Losses $
As of September 30, 2014						
U.S. government agencies	11,637	(53)	19,339	(849)	30,976	(902)
U.S. agency mortgage-backed securities	6,496	(44)	4,447	(143)	10,943	(187)
U.S. agency collateralized mortgage obligations	27,492	(320)	13,172	(415)	40,664	(735)
Corporate bonds	18,388	(94)	6,574	(145)	24,962	(239)
Obligations of states & political subdivisions	5,794	(33)	20,704	(396)	26,498	(429)
Total debt securities	69,807	(544)	64,236	(1,948)	134,043	(2,492)
Marketable equity securities	205	(19)	—	—	205	(19)
Total temporarily impaired securities	70,012	(563)	64,236	(1,948)	134,248	(2,511)
As of December 31, 2013						
U.S. government agencies	33,043	(1,735)	3,603	(417)	36,646	(2,152)
U.S. agency mortgage-backed securities	31,810	(659)	4,938	(21)	36,748	(680)
U.S. agency collateralized mortgage obligations	28,138	(938)	—	—	28,138	(938)
Private collateralized mortgage obligations	1,384	(59)	1,790	(79)	3,174	(138)
Corporate bonds	32,349	(664)	2,010	(9)	34,359	(673)
Obligations of states & political subdivisions	58,920	(2,778)	8,950	(571)	67,870	(3,349)
Total temporarily impaired securities	185,644	(6,833)	21,291	(1,097)	206,935	(7,930)

There were four equity securities that were considered temporarily impaired at September 30, 2014, but none at December 31, 2013. The temporarily impaired equity securities are all bank stocks held at the holding company which are subject to market value adjustments based on volatile stock prices. In the debt security portfolio, there are 95 positions that were considered temporarily impaired at September 30, 2014. There were no instruments considered to be other-than-temporarily impaired at September 30, 2014.

The Corporation evaluates both equity and fixed maturity positions for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic and market concerns warrant such evaluation. U.S. generally accepted accounting principles provide for the bifurcation of OTTI into two categories: (a) the amount of the total OTTI related to a decrease in cash flows expected to be collected from the debt security (the credit loss), which is recognized in earnings, and (b) the amount of total OTTI related to all other factors, which is recognized, net of taxes, as a component of accumulated other comprehensive income. This accounting treatment was only applicable to two of the Corporation's PCMOs in the first quarter of 2014, but both of those securities were sold in the second quarter of 2014, resulting in no further impairment charges.

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The prior impairment on the PCMOs was a result of a deterioration of expected cash flows on those securities due to higher projected credit losses than the amount of credit protection carried by those securities. Specifically, the foreclosure and severity rates had been running at levels where expected principal losses were in excess of the remaining credit protection on those instruments. The projected principal losses were based on prepayment speeds that were equal to or slower than the actual last twelve-month prepayment speeds the particular securities had experienced. Every quarter prior to the second quarter of 2014, management evaluated third-party reporting that showed projected principal losses based on various prepayment speed and severity rate scenarios. Based on the assumption that all loans over 60 days delinquent would default and at a severity rate equal to or above that previously experienced, and based on historical and expected prepayment speeds, management determined that it was appropriate to take an additional $22,000 of impairment on one PCMO in the first quarter of 2014. Because all of the remaining PCMOs were sold in the second quarter of 2014, no further impairment was recorded on these bonds in 2014 and future impairment analysis will cease for this segment since it was completely sold off.

The following tables reflect the amortized cost, market value, and unrealized loss as of September 30, 2014 and 2013, on the PCMO securities held which had impairment taken in each respective year. In 2014, there was one PCMO that had impairment taken during the first quarter prior to the sale of the remaining PCMO portfolio. In 2013, there were three PCMOs that had impairment taken in the year-to-date period. The values shown below are after the Corporation recorded year-to-date impairment charges of $22,000 through September 30, 2014, and $157,000 through September 30, 2013. The $22,000 and $157,000 are deemed to be credit losses and are the amounts that management expects the principal losses would be by the time these securities mature. The remaining $166,000 of unrealized losses as of September 30, 2013, was deemed to be market value losses that were considered temporary. Because all of the remaining PCMO securities were sold during the second quarter of 2014, there are no temporary market value losses remaining at September 30, 2014.

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SECURITY IMPAIRMENT CHARGES

(DOLLARS IN THOUSANDS)

	As of September 30, 2014			
	Book Value	Market Value	Unrealized Loss	Impairment Charge
	$	$	$	$
Impaired private collateralized mortgage obligations	—	—	—	(22)

	As of September 30, 2013			
	Book Value	Market Value	Unrealized Loss	Impairment Charge
	$	$	$	$
Impaired private collateralized mortgage obligations	3,411	3,245	(166)	(157)

The following table provides a cumulative roll forward of credit losses recognized in earnings for debt securities held:

CREDIT LOSSES RECOGNIZED IN EARNINGS ON DEBT SECURITIES

(DOLLARS IN THOUSANDS)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	$	$	$	$
Beginning balance	—	1,090	1,148	977
Credit losses on debt securities for which other-than-temporary impairment has not been previously recognized	—	—	—	—
Additional credit losses on debt securities for which other-than-temporary impairment was previously recognized	—	44	22	157

Sale of debt securities with previously recognized impairment	—	(89)	(1,170)	(89)
Ending balance	—	1,045	—	1,045

With the sale of the remaining PCMO portfolio during the second quarter of 2014, there are no remaining impairment balances as of September 30, 2014.

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Notes to the Unaudited Consolidated Interim Financial Statements
3. Loans and Allowance for Loan Losses

The following table presents the Corporation's loan portfolio by category of loans as of September 30, 2014, and December 31, 2013.

LOAN PORTFOLIO

(DOLLARS IN THOUSANDS)

	September 30, 2014	December 31, 2013
	$	$
Commercial real estate		
Commercial mortgages	95,173	97,243
Agriculture mortgages	133,588	114,533
Construction	9,054	9,399
Total commercial real estate	237,815	221,175
Consumer real estate (a)		
1-4 family residential mortgages	123,203	127,253
Home equity loans	9,915	10,889
Home equity lines of credit	26,672	21,097
Total consumer real estate	159,790	159,239
Commercial and industrial		
Commercial and industrial	29,366	28,719
Tax-free loans	12,550	10,622
Agriculture loans	14,089	14,054
Total commercial and industrial	56,005	53,395
Consumer	3,833	4,063
Gross loans prior to deferred fees	457,443	437,872
Less:		
Deferred loan costs, net	(430)	(348)
Allowance for loan losses	6,968	7,219
Total net loans	450,905	431,001

(a) Real estate loans serviced for others, which are not included in the Consolidated Balance Sheets, totaled $12,523,000 and $4,866,000 as of September 30, 2014, and December 31, 2013, respectively.

The Corporation grades commercial credits differently than consumer credits. The following tables represent all of the Corporation’s commercial credit exposures by internally assigned grades as of September 30, 2014 and December 31, 2013. The grading analysis estimates the capability of the borrower to repay the contractual obligations under the loan agreements as scheduled. The Corporation's internal commercial credit risk grading system is based on experiences with similarly graded loans.

The Corporation's internally assigned grades for commercial credits are as follows:

- Pass – loans which are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral.

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

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

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

- Loss – loans classified as a loss are considered uncollectible, or of such value that continuance as an asset is not warranted.

COMMERCIAL CREDIT EXPOSURE

CREDIT RISK PROFILE BY INTERNALLY ASSIGNED GRADE

(DOLLARS IN THOUSANDS)

September 30, 2014	Commercial Mortgages	Agriculture Mortgages	Construction	Commercial and Industrial	Tax-free Loans	Agriculture Loans	Total
	$	$	$	$	$	$	$
Grade:							
Pass	86,244	130,156	7,139	28,089	12,550	13,611	277,789
Special Mention	3,165	1,250	—	203	—	278	4,896
Substandard	5,764	2,182	1,915	1,074	—	200	11,135
Doubtful	—	—	—	—	—	—	—
Loss	—	—	—	—	—	—	—
Total	95,173	133,588	9,054	29,366	12,550	14,089	293,820

December 31, 2013	Commercial Mortgages	Agriculture Mortgages	Construction	Commercial and Industrial	Tax-free Loans	Agriculture Loans	Total
	$	$	$	$	$	$	$
Grade:							
Pass	85,683	112,253	7,402	27,082	10,390	13,425	256,235
Special Mention	4,996	—	—	213	—	293	5,502
Substandard	6,564	2,280	1,997	1,424	232	336	12,833
Doubtful	—	—	—	—	—	—	—
Loss	—	—	—	—	—	—	—
Total	97,243	114,533	9,399	28,719	10,622	14,054	274,570

For consumer loans, the Corporation evaluates credit quality based on whether the loan is considered performing or non-performing. Non-performing loans consist of those loans greater than 90 days delinquent and nonaccrual loans.

The following tables present the balances of consumer loans by classes of the loan portfolio based on payment performance as of September 30, 2014 and December 31, 2013:

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CONSUMER CREDIT EXPOSURE

CREDIT RISK PROFILE BY PAYMENT PERFORMANCE

(DOLLARS IN THOUSANDS)

September 30, 2014	1-4 Family Residential Mortgages	Home Equity Loans	Home Equity Lines of Credit	Consumer	Total
Payment performance:	$	$	$	$	$
Performing	123,055	9,845	26,672	3,831	163,403
Non-performing	148	70	—	2	220
Total	123,203	9,915	26,672	3,833	163,623

December 31, 2013	1-4 Family Residential Mortgages	Home Equity Loans	Home Equity Lines of Credit	Consumer	Total
Payment performance:	$	$	$	$	$
Performing	127,039	10,889	21,097	4,046	163,071
Non-performing	214	—	—	17	231
Total	127,253	10,889	21,097	4,063	163,302

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The following tables present an age analysis of the Corporation's past due loans, segregated by loan portfolio class, as of September 30, 2014 and December 31, 2013:

AGING OF LOANS RECEIVABLE

(DOLLARS IN THOUSANDS)

September 30, 2014	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans Receivable	Loans Receivable > 90 Days and Accruing
	$	$	$	$	$	$	$
Commercial real estate							
Commercial mortgages	—	193	449	642	94,531	95,173	—
Agriculture mortgages	—	—	—	—	133,588	133,588	—
Construction	—	—	—	—	9,054	9,054	—
Consumer real estate							
1-4 family residential mortgages	678	346	148	1,172	122,031	123,203	148
Home equity loans	62	17	70	149	9,766	9,915	70
Home equity lines of credit	—	—	—	—	26,672	26,672	—
Commercial and industrial							
Commercial and industrial	—	65	130	195	29,171	29,366	—
Tax-free loans	—	—	—	—	12,550	12,550	—
Agriculture loans	—	—	—	—	14,089	14,089	—
Consumer	15	4	2	21	3,812	3,833	2
Total	755	625	799	2,179	455,264	457,443	220

December 31, 2013	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans Receivable	Loans Receivable > 90 Days and Accruing
	$	$	$	$	$	$	$
Commercial real estate							
Commercial mortgages	—	205	—	205	97,038	97,243	—
Agriculture mortgages	69	—	—	69	114,464	114,533	—
Construction	—	—	—	—	9,399	9,399	—
Consumer real estate							
1-4 family residential mortgages	1,089	401	214	1,704	125,549	127,253	214
Home equity loans	57	—	—	57	10,832	10,889	—
Home equity lines of credit	15	13	—	28	21,069	21,097	—
Commercial and industrial							

Commercial and industrial	20	—	—	20	28,699	28,719	—
Tax-free loans	—	—	—	—	10,622	10,622	—
Agriculture loans	—	—	—	—	14,054	14,054	—
Consumer	10	13	17	40	4,023	4,063	17
Total	1,260	632	231	2,123	435,749	437,872	231

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The following table presents nonaccrual loans by classes of the loan portfolio as of September 30, 2014 and December 31, 2013:

NONACCRUAL LOANS BY LOAN CLASS

(DOLLARS IN THOUSANDS)

	September 30, 2014	December 31, 2013
	$	$
Commercial real estate		
Commercial mortgages	1,289	992
Agriculture mortgages	—	—
Construction	—	—
Consumer real estate		
1-4 family residential mortgages	—	—
Home equity loans	—	—
Home equity lines of credit	—	—
Commercial and industrial		
Commercial and industrial	76	109
Tax-free loans	—	—
Agriculture loans	—	—
Consumer	—	—
Total	1,365	1,101

As of September 30, 2014 and December 31, 2013, all of the Corporation's commercial loans on nonaccrual status were also considered impaired. Information with respect to impaired loans for the three and nine months ended September 30, 2014 and September 30, 2013, is as follows:

IMPAIRED LOANS

(DOLLARS IN THOUSANDS)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
	$	$	$	$

Average recorded balance of impaired loans	2,534	2,853	2,589	2,862
Interest income recognized on impaired loans	27	28	81	85

Interest income on impaired loans would have increased by approximately $9,000 and $32,000 for the three and nine months ended September 30, 2014, respectively, compared to $22,000 and $64,000 for the three and nine months ended September 30, 2013, had these loans performed in accordance with their original terms.

During the nine months ended September 30, 2014 and 2013, there were no loan modifications made that would cause a loan to be considered a troubled debt restructuring (TDR). A TDR is a loan where management has granted a concession to the borrower from the original terms. A concession is generally granted in order to improve the financial condition of the borrower and improve the likelihood of full collection by the lender. A concession is generally defined as more favorable payment or credit terms granted to a borrower in an effort to improve the likelihood of the lender collecting principal in its entirety. Concessions usually are in the form of interest only for a period of time, or a lower interest rate offered in an effort to enable the borrower to continue to make normally scheduled payments.

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The following tables summarize information in regards to impaired loans by loan portfolio class as of September 30, 2014, December 31, 2013, and September 30, 2013:

IMPAIRED LOAN ANALYSIS
(DOLLARS IN THOUSANDS)

September 30, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
	$	$	$	$	$
With no related allowance recorded:					
Commercial real estate					
Commercial mortgages	1,289	1,386	—	924	—
Agriculture mortgages	1,556	1,556	—	1,574	81
Construction	—	—	—	—	—
Total commercial real estate	2,845	2,942	—	2,498	81
Commercial and industrial					
Commercial and industrial	76	76	—	91	—
Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	76	76	—	91	—
Total with no related allowance	2,921	3,018	—	2,589	81
With an allowance recorded:					
Commercial real estate					
Commercial mortgages	—	—	—	—	—
Agriculture mortgages	—	—	—	—	—
Construction	—	—	—	—	—
Total commercial real estate	—	—	—	—	—
Commercial and industrial					
Commercial and industrial	—	—	—	—	—
Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	—	—	—	—	—
Total with a related allowance	—	—	—	—	—
Total by loan class:					
Commercial real estate					
Commercial mortgages	1,289	1,386	—	924	—
Agriculture mortgages	1,556	1,556	—	1,574	81

Construction	—	—	—	—	—
Total commercial real estate	2,845	2,942	—	2,498	81
Commercial and industrial					
Commercial and industrial	76	76	—	91	—
Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	76	76	—	91	—
Total	2,921	3,018	—	2,589	81

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IMPAIRED LOAN ANALYSIS
(DOLLARS IN THOUSANDS)

December 31, 2013	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
	$	$	$	$	$
With no related allowance recorded:					
Commercial real estate					
Commercial mortgages	992	1,088	—	1,119	1
Agriculture mortgages	1,592	1,592	—	1,609	112
Construction	—	—	—	—	—
Total commercial real estate	2,584	2,680	—	2,728	113
Commercial and industrial					
Commercial and industrial	109	109	—	99	
Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	109	109	—	99	—
Total with no related allowance	2,693	2,789	—	2,827	113
With an allowance recorded:					
Commercial real estate					
Commercial mortgages	—	—	—	—	—
Agriculture mortgages	—	—	—	—	—
Construction	—	—	—	—	—
Total commercial real estate	—	—	—	—	—
Commercial and industrial					
Commercial and industrial	—	—	—	—	—
Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	—	—	—	—	—
Total with a related allowance	—	—	—	—	—
Total by loan class:					
Commercial real estate					
Commercial mortgages	992	1,088	—	1,119	1
Agriculture mortgages	1,592	1,592	—	1,609	112
Construction	—	—	—	—	—
Total commercial real estate	2,584	2,680	—	2,728	113
Commercial and industrial					
Commercial and industrial	109	109	—	99	—

Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	109	109	—	99	—
Total	2,693	2,789	—	2,827	113

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IMPAIRED LOAN ANALYSIS
(DOLLARS IN THOUSANDS)

September 30, 2013	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
	$	$	$	$	$
With no related allowance recorded:					
Commercial real estate					
Commercial mortgages	1,224	1,321	—	1,159	1
Agriculture mortgages	1,603	1,603	—	1,613	84
Construction	—	—	—	—	—
Total commercial real estate	2,827	2,924	—	2,772	85
Commercial and industrial					
Commercial and industrial	31	31	—	45	—
Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	31	31	—	45	—
Total with no related allowance	2,858	2,955	—	2,817	85
With an allowance recorded:					
Commercial real estate					
Commercial mortgages	—	—	—	—	—
Agriculture mortgages	—	—	—	—	—
Construction	—	—	—	—	—
Total commercial real estate	—	—	—	—	—
Commercial and industrial					
Commercial and industrial	102	102	8	45	—
Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	102	102	8	45	—
Total with a related allowance	102	102	8	45	—
Total by loan class:					
Commercial real estate					
Commercial mortgages	1,224	1,321	—	1,159	1
Agriculture mortgages	1,603	1,603	—	1,613	84
Construction	—	—	—	—	—
Total commercial real estate	2,827	2,924	—	2,772	85
Commercial and industrial					
Commercial and industrial	133	133	8	90	—

Tax-free loans	—	—	—	—	—
Agriculture loans	—	—	—	—	—
Total commercial and industrial	133	133	8	90	—
Total	2,960	3,057	8	2,862	85

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The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2014:

ALLOWANCE FOR CREDIT LOSSES

(DOLLARS IN THOUSANDS)

	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial	Consumer	Unallocated	Total
	$	$	$	$	$	$
Allowance for credit losses:						
Beginning balance - December 31, 2013	3,657	1,346	1,416	102	698	7,219
Charge-offs	—	—	—	(15)	—	(15)
Recoveries	4	5	43	—	—	52
Provision	(150)	51	(117)	17	(1)	(200)(1)
Balance - March 31, 2014	3,511	1,402	1,342	104	697	7,056
Charge-offs	—	—	—	—	—	—
Recoveries	3	—	9	—	—	12
Provision	(106)	44	12	(24)	(26)	(100)(1)
Ending Balance - June 30, 2014	3,408	1,446	1,363	80	671	6,968
Charge-offs	—	—	(12)	(2)	—	(14)
Recoveries	—	—	14	—	—	14
Provision	159	(34)	(74)	3	(54)	—
Ending Balance - September 30, 2014	3,567	1,412	1,291	81	617	6,968

(1) The Corporation recognized a $200,000 credit provision in the first quarter of 2014 and a $100,000 credit provision in the second quarter of 2014 as a result of lower levels of substandard loans, and continued low levels of total classified loans, impaired loans, non-accrual loans, recoveries in excess of charge-offs, continuing declines in historic loss ratio, and improving qualitative factors.

During the nine months ended September 30, 2014, credit provisions were recorded for the commercial real estate, commercial and industrial, and consumer loan categories while there was a small provision expense required for the consumer real estate loan category. There have been no commercial loan charge-offs during the past year, which

reduced the historical loss rates and ultimately resulted in a lower required reserve amount for the commercial loan categories. Qualitative factors have been shifting, with some increasing and some decreasing, but overall, qualitative factors across the board have been declining. Conversely, factors in the allowance calculation related to consumer real estate were increased in the first nine months of 2014 as a result of the mortgage initiative and focus on increasing volume in this area.

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The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2013:

ALLOWANCE FOR CREDIT LOSSES

(DOLLARS IN THOUSANDS)

	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial	Consumer	Unallocated	Total
	$	$	$	$	$	$
Allowance for credit losses:						
Beginning balance - December 31, 2012	3,575	1,510	1,640	61	730	7,516
Charge-offs	—	(78)	(41)	(6)	—	(125)
Recoveries	—	—	16	—	—	16
Provision	(355)	48	281	7	(31)	(50)(1)
Balance - March 31, 2013	3,220	1,480	1,896	62	699	7,357
Charge-offs	—	—	—	—	—	—
Recoveries	—	—	16	—	—	16
Provision	8	(22)	(107)	19	2	(100)(1)
Ending Balance - June 30, 2013	3,228	1,458	1,805	81	701	7,273
Charge-offs	—	—	—	(10)	—	(10)
Recoveries	—	—	19	1	—	20
Provision	494	(26)	(213)	7	(262)	— (1)
Ending Balance - September 30, 2013	3,722	1,432	1,611	79	439	7,283

(1) The Corporation recognized a $50,000 credit provision in the first quarter of 2013, and a $100,000 credit provision in the second quarter of 2013, with no provision recorded in the third quarter of 2013, for a total year-to-date credit provision of $150,000, as a result of lower levels of non-performing and delinquent loans, and minimum charge-offs.

During the first quarter of 2013, a large commercial real estate (CRE) loan was upgraded and was no longer considered substandard, reducing the required provision for this loan type. Conversely, a commercial and industrial (C&I) loan moved from pass to substandard increasing the related required provision. In the second quarter of 2013,

paydowns and payoffs of C&I loans reduced the required provision. This continued in the third quarter of 2013 including the upgrading of a C&I loan. The sharp third quarter increase in both commercial real estate and agricultural real estate loans, which are included in the same column, was primarily responsible for the sharp increase in the provision for these loans.

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

ALLOWANCE FOR CREDIT LOSSES AND RECORDED INVESTMENT IN LOANS RECEIVABLE

(DOLLARS IN THOUSANDS)

As of September 30, 2014:	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial	Consumer	Unallocated	Total
	$	$	$	$	$	$
Allowance for credit losses:						
Ending balance: individually evaluated for impairment	—	—	—	—	—	—
Ending balance: collectively evaluated for impairment	3,567	1,412	1,291	81	617	6,968
Loans receivable:						
Ending balance	237,815	159,790	56,005	3,833		457,443
Ending balance: individually evaluated for impairment	2,845	—	76	—		2,921
Ending balance: collectively evaluated for impairment	234,970	159,790	55,929	3,833		454,522

As of December 31, 2013:	Commercial Real Estate	Consumer Real Estate	Commercial and Industrial	Consumer	Unallocated	Total
	$	$	$	$	$	$
Allowance for credit losses:						
Ending balance: individually evaluated for impairment	—	—	—	—	—	—
Ending balance: collectively evaluated for impairment	3,657	1,346	1,416	102	698	7,219
Loans receivable:						
Ending balance	221,175	159,239	53,395	4,063		437,872
Ending balance: individually evaluated for impairment	2,584	—	109	—		2,693
Ending balance: collectively evaluated for impairment	218,591	159,239	53,286	4,063		435,179

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4. Fair Value Presentation

U.S. generally accepted accounting principles establish a hierarchal disclosure framework associated with the level of observable pricing utilized in measuring assets and liabilities at fair value. The three broad levels defined by the hierarchy are as follows:

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

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

Level III: Assets and liabilities that have little to no observable pricing as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

The following tables present the assets reported on the consolidated balance sheets at their fair value as of September 30, 2014, and December 31, 2013, by level within the fair value hierarchy. As required by U.S. generally accepted accounting principles, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

Fair Value Measurements:

ASSETS MEASURED ON A RECURRING BASIS

(DOLLARS IN THOUSANDS)

	September 30, 2014			
	Level I	Level II	Level III	Total
	$	$	$	$
U.S. government agencies	—	36,830	—	36,830
U.S. agency mortgage-backed securities	—	46,736	—	46,736
U.S. agency collateralized mortgage obligations	—	58,723	—	58,723

Corporate bonds	—	52,988	—	52,988
Obligations of states & political subdivisions	—	100,657	—	100,657
Marketable equity securities	5,363	—	—	5,363
Total securities	5,363	295,934	—	301,297

On September 30, 2014, the Corporation held no securities valued using level III inputs. All of the Corporation's debt instruments were valued using level II inputs, where quoted prices are available and observable, but not necessarily quotes on identical securities traded in active markets on a daily basis. The Corporation's CRA fund investments and bank stocks are fair valued utilizing level I inputs because the funds have their own quoted prices in an active market. As of September 30, 2014, the CRA fund investments had a $5,000,000 book and fair market value and the bank stock portfolio had a book value of $376,000, and fair market value of $363,000.

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Fair Value Measurements:

ASSETS MEASURED ON A RECURRING BASIS

(DOLLARS IN THOUSANDS)

	December 31, 2013			
	Level I	Level II	Level III	Total
	$	$	$	$
U.S. government agencies	—	39,667	—	39,667
U.S. agency mortgage-backed securities	—	51,923	—	51,923
U.S. agency collateralized mortgage obligations	—	41,688	—	41,688
Private collateralized mortgage obligations	—	4,041	—	4,041
Corporate bonds	—	56,194	—	56,194
Obligations of states & political subdivisions	—	101,644	—	101,644
Marketable equity securities	5,171	—	—	5,171
Total securities	5,171	295,157	—	300,328

On December 31, 2013, the Corporation held no securities valued using level III inputs. All of the Corporation's debt instruments were valued using level II inputs, where quoted prices are available and observable but not necessarily quotes on identical securities traded in active markets on a daily basis. As of December 31, 2013, the Corporation's CRA fund investments had a book and fair market value of $5,000,000 and the bank stock portfolio had a book value of $151,000 and a market value of $171,000 utilizing level I pricing.

Financial instruments are considered level III when their values are determined using pricing models, discounted cash flow methodologies, or similar techniques, and at least one significant model assumption or input is unobservable. In addition to these unobservable inputs, the valuation models for level III financial instruments typically also rely on a number of inputs that are readily observable either directly or indirectly. Level III financial instruments also include those for which the determination of fair value requires significant management judgment or estimation. There were no level III securities as of September 30, 2014 or December 31, 2013.

The following tables present the assets measured on a nonrecurring basis on the Consolidated Balance Sheets at their fair value as of September 30, 2014 and December 31, 2013, by level within the fair value hierarchy:

ASSETS MEASURED ON A NONRECURRING BASIS

(Dollars in Thousands)

	September 30, 2014			
	Level I $	Level II $	Level III $	Total $
Assets:				
Impaired Loans	—	—	2,921	2,921
OREO	—	—	**24**	24
Total	—	—	2,945	2,945

	December 31, 2013			
	Level I $	Level II $	Level III $	Total $
Assets:				
Impaired Loans	—	—	2,693	2,693
OREO	—	—	39	39
Total	—	—	2,732	2,732

The Corporation had a total of $2,921,000 of impaired loans as of September 30, 2014, and $2,693,000 of impaired loans as of December 31, 2013, with no specific allocation against these loans. The value of impaired loans is generally determined through independent appraisals of the underlying collateral.

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Other real estate owned (OREO) is measured at fair value, less estimated costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management. The assets are carried at the lower of carrying amount or fair value, less estimated costs to sell. The Corporation's OREO balance consisted of one residential property that was classified as OREO as of September 30, 2014, and a different residential property that was classified as OREO as of December 31, 2013, and sold prior to September 30, 2014. Management has estimated the current value of the OREO property held at September 30, 2014, at $24,000 utilizing level III pricing. Income and expenses from operations and changes in valuation allowance are included in the net expenses from OREO.

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis for which the Corporation has utilized level III inputs to determine fair value:

QUANTITATIVE INFORMATION ABOUT LEVEL III FAIR VALUE MEASUREMENTS

(DOLLARS IN THOUSANDS)

September 30, 2014:	Fair Value Estimate $	Valuation Techniques $	Unobservable Input	Range (Weighted Avg)
Impaired loans	2,921	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to -20% (-20%)
			Liquidation expenses (2)	0% to -10% (-10%)
OREO	24	Appraisal of collateral (1),(3)	Liquidation expenses (2)	-1% to -7% (-7%)
December 31, 2013:				
Impaired loans	2,693	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to -20% (-20%)
			Liquidation expenses (2)	0% to -10% (-10%)
OREO	39	Appraisal of collateral (1),(3)	Liquidation expenses (2)	-1% to -7% (-7%)

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various level III inputs which are not identifiable.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

(3) Includes qualitative adjustments by management and estimated liquidation expenses.

5. Interim Disclosures about Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Cash and Cash Equivalents

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

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Securities Available for Sale

Management utilizes quoted market pricing for the fair value of the Corporation's securities that are available for sale, if available. If a quoted market rate is not available, fair value is estimated using quoted market prices for similar securities.

Loans Held for Sale

Loans held for sale are individual loans for which the Corporation has a firm sales commitment; therefore, the carrying value is a reasonable estimate of the fair value.

Loans

The fair value of fixed and variable rate loans is estimated by discounting back the scheduled future cash flows of the particular loan product, using the market interest rates of comparable loan products in the Corporation's greater market area, with the same general structure, comparable credit ratings, and for the same remaining maturities.

Regulatory Stock

Regulatory stock is valued at a stable dollar price, which is the price used to purchase or liquidate shares; therefore, the carrying amount is a reasonable estimate of fair value.

Bank Owned Life Insurance

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

Accrued Interest Receivable

The carrying amount of accrued interest receivable is a reasonable estimate of fair value.

Deposits

The fair value of non-interest bearing demand deposit accounts and interest bearing demand, savings, and money market deposit accounts is based on the amount payable on demand at the reporting date. The fair value of

fixed-maturity time deposits is estimated by discounting back the expected cash flows of the time deposit using market interest rates from the Corporation's greater market area currently offered for similar time deposits with similar remaining maturities.

Borrowings

The fair value of a term borrowing is estimated by comparing the rate currently offered for the same type of borrowing instrument with a matching remaining term.

Accrued Interest Payable

The carrying amount of accrued interest payable is a reasonable estimate of fair value.

Firm Commitments to Extend Credit, Lines of Credit, and Open Letters of Credit

These financial instruments are generally not subject to sale and estimated fair values are not readily available. The carrying value, represented by the net deferred fee arising from the unrecognized commitment or letter of credit, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment, using fees currently charged to enter into similar agreements with similar credit risk, is not considered material for disclosure purposes. The contractual amounts of unfunded commitments are presented in Note 6.

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Fair Value of Financial Instruments

The carrying amounts and estimated fair values of the Corporation's financial instruments at September 30, 2014 and December 31, 2013, are summarized as follows:

FAIR VALUE OF FINANCIAL INSTRUMENTS

(DOLLARS IN THOUSANDS)

	September 30, 2014				
	Carrying Amount $	Fair Value $	Quoted Prices in Active Markets for Identical Assets (Level 1) $	Significant Other Observable Inputs (Level II) $	Significant Unobservable Inputs (Level III) $
Financial Assets:					
Cash and cash equivalents	44,079	44,079	44,079	—	—
Securities available for sale	301,297	301,297	5,363	295,934	—
Loans held for sale	257	257	257	—	—
Loans, net of allowance	450,905	449,044	—	—	449,044
Regulatory stock	4,184	4,184	4,184	—	—
Bank owned life insurance	20,406	20,406	20,406	—	—
Accrued interest receivable	3,397	3,397	3,397	—	—
Financial Liabilities:					
Demand deposits	188,391	188,391	188,391	—	—
Interest-bearing demand deposits	11,647	11,647	11,647	—	—
NOW accounts	78,285	78,285	78,285	—	—
Savings accounts	127,928	127,928	127,928	—	—
Money market deposit accounts	66,588	66,588	66,588	—	—
Time deposits	214,505	216,921	—	—	216,921
Total deposits	687,344	689,760	472,839	—	216,921
Short-term borrowings	7,260	7,260	7,260	—	—
Long-term debt	62,300	63,255	—	—	63,255
Accrued interest payable	599	599	599	—	—

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FAIR VALUE OF FINANCIAL INSTRUMENTS

(DOLLARS IN THOUSANDS)

	December 31, 2013				
	Carrying Amount $	Fair Value $	Quoted Prices in Active Markets for Identical Assets (Level 1) $	Significant Other Observable Inputs (Level II) $	Significant Unobservable Inputs (Level III) $
Financial Assets:					
Cash and cash equivalents	24,577	24,577	24,577	—	—
Securities available for sale	300,328	300,328	5,171	295,157	—
Loans held for sale	59	59	59	—	
Loans, net of allowance	431,001	434,049	—	—	434,049
Regulatory stock	3,660	3,660	3,660	—	—
Bank owned life insurance	19,911	19,911	19,911	—	—
Accrued interest receivable	3,605	3,605	3,605	—	—
Financial Liabilities:					
Demand deposits	173,070	173,070	173,070	—	—
Interest-bearing demand deposits	13,055	13,055	13,055	—	—
NOW accounts	70,540	70,540	70,540	—	—
Savings accounts	120,935	120,935	120,935	—	—
Money market deposit accounts	61,882	61,882	61,882	—	—
Time deposits	217,144	221,172	—	—	221,172
Total deposits	656,626	660,654	439,482	—	221,172
Short-term borrowings	3,900	3,900	3,900	—	—
Long-term debt	65,000	66,934	—	—	66,934
Accrued interest payable	699	699	699	—	—

6. Commitments and Contingent Liabilities

In order to meet the financing needs of its customers in the normal course of business, the Corporation makes various commitments that are not reflected in the accompanying consolidated financial statements. These commitments include firm commitments to extend credit, unused lines of credit, and open letters of credit. As of September 30, 2014, firm loan commitments were $14.3 million, unused lines of credit were $142.9 million, and open letters of credit were $10.3 million. The total of these commitments was $167.5 million, which represents the Corporation's exposure to credit loss in the event of nonperformance by its customers with respect to these financial instruments. The actual credit losses that may arise from these commitments are expected to compare favorably with the

Corporation's loan loss experience on its loan portfolio taken as a whole. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for balance sheet financial instruments.

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7. Accumulated Other Comprehensive Income (Loss)

The activity in accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2014 and 2013 is as follows:

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ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (1) (2)

(DOLLARS IN THOUSANDS)

	Unrealized Gains (Losses) on Securities Available-for-Sale
Balance at December 31, 2013	$ (3,940)
Other comprehensive income before reclassifications	2,610
Amount reclassified from accumulated other comprehensive income (loss)	(437)
Period change	2,173
Balance at March 31, 2014	(1,767)
Other comprehensive income before reclassifications	1,962
Amount reclassified from accumulated other comprehensive income (loss)	(384)
Period change	1,578
Balance at June 30, 2014	(189)
Other comprehensive income before reclassifications	1,267
Amount reclassified from accumulated other comprehensive income (loss)	(412)
Period change	855
Balance at September 30, 2014	666
Balance at December 31, 2012	6,663
Other comprehensive income (loss) before reclassifications	(712)
Amount reclassified from accumulated other comprehensive income (loss)	(606)
Period change	(1,318)
Balance at March 31, 2013	5,345
Other comprehensive income (loss) before reclassifications	(6,000)
Amount reclassified from accumulated other comprehensive income (loss)	(428)
Period change	(6,428)
Balance at June 30, 2013	(1,083)
Other comprehensive income (loss) before reclassifications	(600)
Amount reclassified from accumulated other comprehensive income (loss)	(326)
Period change	(926)
Balance at September 30, 2013	(2,009)

(1) All amounts are net of tax. Related income tax expense or benefit is calculated using a Federal income tax rate of 34%.

(2) Amounts in parentheses indicate debits.

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DETAILS ABOUT ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) COMPONENTS (1)

(DOLLARS IN THOUSANDS)

	Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Three Months Ended September 30,		
	2014 $	2013 $	Affected Line Item in the Statements of Income
Securities available-for-sale:			
Net securities gains reclassified into earnings	624	537	Gains on securities transactions, net
Related income tax expense	(212)	(182)	Provision for federal income taxes
Net effect on accumulated other comprehensive income for the period	412	355	
Net impairment losses reclassified into earnings	—	(44)	Net impairment losses on investment securities
Related income tax expense	—	15	Provision for federal income taxes
Net effect on accumulated other comprehensive income for the period	—	(29)	
Total reclassifications for the period	412	326	

(1) Amounts in parentheses indicate debits.

DETAILS ABOUT ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) COMPONENTS (1)

(DOLLARS IN THOUSANDS)

Amount
Reclassified from

	Accumulated Other Comprehensive Income (Loss) For the Nine Months Ended September 30,		
	2014	2013	Affected Line Item in the
	$	$	Statements of Income
Securities available-for-sale:			
Net securities gains reclassified into earnings	1,891	2,216	Gains on securities transactions, net
Related income tax expense	(643)	(753)	Provision for federal income taxes
Net effect on accumulated other comprehensive income for the period	1,248	1,463	
Net impairment losses reclassified into earnings	(22)	(157)	Net impairment losses on investment securities
Related income tax expense	7	54	Provision for federal income taxes
Net effect on accumulated other comprehensive income for the period	(15)	(103)	
Total reclassifications for the period	1,233	1,360	

(1) Amounts in parentheses indicate debits.

8. Recently Issued Accounting Standards

In June 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2013-08, *Financial Services – Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements.* The amendments in this Update affect the scope, measurement, and disclosure requirements for investment companies under U.S. GAAP. The amendments do all of the following: (1) change the approach to the investment company assessment in Topic 946, clarify the characteristics of an investment company, and provide comprehensive guidance for assessing whether an entity is an investment company; (2) require an investment company to measure noncontrolling ownership interests in other investment companies at fair value rather than using the equity method of accounting; and (3) require the following additional disclosures: (a) the fact that the entity is an investment company and is applying the guidance in Topic 946, (b) information about changes, if any, in an entity's status as an investment company, and (c) information about financial support provided or contractually required to be provided by an investment company to any of its investees. The amendments in this Update are effective for an entity's interim and annual reporting periods in fiscal years that begin after December 15, 2013. Earlier application is prohibited. This Update became effective for the Corporation on January 1, 2014, and did not have a significant impact on the Corporation's financial statements.

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In July 2013, the FASB issued ASU 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.* This Update applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. This Update is not expected to have a significant impact on the Corporation's financial statements.

In January 2014, the FASB issued ASU 2014-01, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects.* The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this Update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. This Update is not expected to have a significant impact on the Corporation's financial statements.

In January 2014, the FASB issued ASU 2014-04, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.* The amendments in this Update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods,

beginning after December 15, 2014. An entity can elect to adopt the amendments in this Update using either a modified retrospective transition method or a prospective transition method. This Update is not expected to have a significant impact on the Corporation's financial statements.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers* (a new revenue recognition standard). The Update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This Update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The Corporation is evaluating the effect of adopting this new accounting Update.

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In June 2014, the FASB issued ASU 2014-10, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. The amendments in this Update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. For repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The amendments also require enhanced disclosures. The accounting changes in this Update are effective for the first interim or annual period beginning after December 15, 2014. An entity is required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Earlier application is prohibited. The disclosure for certain transactions accounted for as a sale is required to be presented for interim and annual periods beginning after December 15, 2014, and the disclosure for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. The disclosures are not required to be presented for comparative periods before the effective date. This Update is not expected to have a significant impact on the Corporation’s financial statements.

In June 2014, the FASB issued ASU 2014-12, *Compensation-Stock Compensation (Topic 718): Accounting for Share-Based Payments when the Terms of an Award Provide that a Performance Target Could Be Achieved After the Requisite Service Period*. The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The amendments in this Update are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. Entities may apply the amendments in this Update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If retrospective transition is adopted, the cumulative effect of applying this Update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. Additionally, if retrospective transition is adopted, an entity may use hindsight in measuring and recognizing the compensation cost. This Update is not expected to have a significant impact on the Corporation’s financial statements.

In August 2014, the FASB issued ASU 2014-14, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40)*. The amendments in this Update require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. This Update is not expected to have a significant impact on the Corporation’s financial statements.

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements -Going Concern (Subtopic* 205-40). The amendments in this Update provide guidance in accounting principles generally accepted in the United States of America about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. This Update is not expected to have a significant impact on the Corporation’s financial statements.

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ENB FINANCIAL CORP
Management's Discussion and Analysis

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

The following discussion and analysis represents management's view of the financial condition and results of operations of the Corporation. This discussion and analysis should be read in conjunction with the consolidated financial statements and other financial schedules included in this quarterly report, and in conjunction with the 2013 Annual Report to Shareholders of the Corporation. The financial condition and results of operations presented are not indicative of future performance.

Forward-Looking Statements

The U.S. Private Securities Litigation Reform Act of 1995 provides safe harbor in regards to the inclusion of forward-looking statements in this document and documents incorporated by reference. Forward-looking statements pertain to possible or assumed future results that are made using current information. These forward-looking statements are generally identified when terms such as: "believe," "estimate," "anticipate," "expect," "project," "forecast," and other similar wordings are used. The readers of this report should take into consideration that these forward-looking statements represent management's expectations as to future forecasts of financial performance, or the likelihood that certain events will or will not occur. Due to the very nature of estimates or predications, these forward-looking statements should not be construed to be indicative of actual future results. Additionally, management may change estimates of future performance, or the likelihood of future events, as additional information is obtained. This document may also address targets, guidelines, or strategic goals that management is striving to reach but may not be indicative of actual results.

Readers should note that many factors affect this forward-looking information, some of which are discussed elsewhere in this document and in the documents that are incorporated by reference into this document. These factors include, but are not limited to, the following:

- National and local economic conditions
- Real estate market and its impact on the loan portfolio
- Monetary and interest rate policies of the Federal Reserve Board
- Volatility of the securities markets including the valuation of securities
- Future actions or inactions of the United States government, including a failure to increase the government debt limit or a prolonged shutdown of the federal government
- Effects of slow economic conditions and the prolonged economic weakness, specifically the effect on loan customers to repay loans
- Political changes and their impact on new laws and regulations
- Competitive forces

- Changes in customer behavior impacting deposit levels and loan demand
- Changes in accounting principles, policies, or guidelines as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board, and other accounting standards setters
- Ineffective business strategy due to current or future market and competitive conditions
- Management's ability to manage credit risk, liquidity risk, interest rate risk, and fair value risk
- Operation, legal, and reputation risk
- Results of the regulatory examination and supervision process
- The risk that our analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful
- The impact of new laws and regulations, including the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the regulations issued thereunder
- Possible impacts of the capital and liquidity requirements of the Basel III standards and other regulatory pronouncements, regulations and rules
- Disruptions due to flooding, severe weather, or other natural disasters or Acts of God.

Readers should be aware if any of the above factors change significantly, the statements regarding future performance could also change materially. The safe harbor provision provides that the Corporation is not required to publicly update or revise forward-looking statements to reflect events or circumstances that arise after the date of this report. Readers should review any changes in risk factors in documents filed by the Corporation periodically with the Securities and Exchange Commission, including Item 1A of Part II of this Quarterly Report on Form 10-Q, Annual Reports on Form 10-K, and Current Reports on Form 8-K.

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ENB FINANCIAL CORP
Management's Discussion and Analysis

Results of Operations

Overview

The Corporation recorded net income of $1,712,000 and $5,290,000 for the three and nine-month periods ended September 30, 2014, respectively, a 1.7% and 5.0% decrease, from the $1,741,000 and $5,571,000 earned during the same periods in 2013. The earnings per share, basic and diluted, were $0.60 and $1.85 for the three and nine months ended September 30, 2014, compared to $0.61 and $1.95 for the same periods in 2013.

The two primary reasons for the decline in earnings were an increase in operational expenses and a decline in gains on security transactions for the year-to-date period. Operating expenses increased by $420,000, or 7.9%, and $1,155,000, or 7.1%, for the three and nine months ended September 30, 2014, compared to the same periods in the prior year. The operational expense increases were largely the result of two additional branches opened during 2013 and the expansion of the Corporation's mortgage division in 2014 and the corresponding costs associated therewith. Net gains on securities increased by $87,000, or 16.2%, for the three-month period ended September 30, 2014, but decreased by $325,000, or 14.7%, for the nine months ended September 30, 2014, compared to the same periods in 2013. More detail is provided under the Other Income and Operating Expense sections under Results of Operations.

The Corporation's net interest income for the three and nine months ended September 30, 2014, increased from the same periods in 2013. Net interest income was $5,541,000 for the third quarter of 2014, compared to $5,423,000 for the same quarter of 2013, a $118,000, or 2.2% increase. Year-to-date net interest income was $16,804,000 as of September 30, 2014, an $897,000, or 5.6% increase from the $15,907,000 earned in the first nine months of 2013. The Corporation's net interest margin was 3.02% for the third quarter of 2014, compared to 3.18% for the third quarter of 2013. The Corporation's year-to-date net interest margin was 3.11% through September 30, 2014, compared to 3.16% for the same period in 2013.

The Corporation recorded no provision expense or credit provision for the third quarters of 2014 or 2013, but recorded a credit provision for loan losses of $300,000 for the year-to-date period compared to a credit provision of $150,000 for the respective period in 2013. Improvements in asset quality, as evidenced by low levels of non-performing and delinquent loans, and minimal charge-offs allowed the Corporation to reverse a portion of the allowance for loan losses into earnings in 2013 and 2014, while still maintaining sufficient coverage ratios. With the credit provisions in 2013 and 2014, the allowance for loan losses as a percentage of total loans declined to 1.52% as of September 30, 2014, compared to 1.67% as of September 30, 2013. More detail is provided in the Provision for Loan Losses section that follows and the Allowance for Loan Losses section under Financial Condition.

The financial services industry uses two primary performance measurements to gauge performance: return on average assets (ROA) and return on average equity (ROE). ROA measures how efficiently a bank generates income based on the amount of assets or size of a company. ROE measures the efficiency of a company in generating income based on the amount of equity or capital utilized. The latter measurement typically receives more attention from shareholders. The ROA and ROE decreased for the three and nine-month periods ended September 30, 2014, compared to the same periods in the prior year due to the decrease in the Corporation's income and an increase in capital levels.

Key Ratios	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Return on Average Assets	0.80%	0.86%	0.85%	0.93%
Return on Average Equity	7.55%	8.37%	8.05%	8.55%

The results of the Corporation's operations are best explained by addressing, in further detail, the five major sections of the income statement, which are as follows:

- Net interest income
- Provision for loan losses

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ENB FINANCIAL CORP
Management's Discussion and Analysis

- Other income
- Operating expenses
- Provision for income taxes

The following discussion analyzes each of these five components.

Net Interest Income

Net interest income (NII) represents the largest portion of the Corporation's operating income. In the first nine months of 2014, NII generated 71.7% of the Corporation's gross revenue stream, which consists of net interest income and non-interest income, compared to 70.5% in the first nine months of 2013. The overall performance of the Corporation is highly dependent on the changes in net interest income since it comprises such a significant portion of operating income.

The following table shows a summary analysis of net interest income on a fully taxable equivalent (FTE) basis. For analytical purposes and throughout this discussion, yields, rates, and measurements such as NII, net interest spread, and net yield on interest earning assets are presented on an FTE basis. The FTE net interest income shown in both tables below will exceed the NII reported on the consolidated statements of income, which is not shown on an FTE basis. The amount of FTE adjustment totaled $468,000 and $1,415,000 for the three and nine months ended September 30, 2014, compared to $548,000 and $1,684,000 for the same periods in 2013.

NET INTEREST INCOME

(DOLLARS IN THOUSANDS)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	$	$	$	$
Total interest income	6,696	6,745	20,393	20,007
Total interest expense	1,155	1,322	3,589	4,100
Net interest income	5,541	5,423	16,804	15,907
Tax equivalent adjustment	468	548	1,415	1,684

Net interest income (fully taxable equivalent)	6,009	5,971	18,219	17,591

NII is the difference between interest income earned on assets and interest expense incurred on liabilities. Accordingly, two factors affect net interest income:

- The rates charged on interest earning assets and paid on interest bearing liabilities
- The average balance of interest earning assets and interest bearing liabilities

The Federal funds rate, the Prime rate, and the shape of the U.S. Treasury curve all affect net interest income, in addition to all of the economic, competitive, and regulatory factors previously listed.

The Federal funds rate, which is the overnight rate that financial institutions charge other financial institutions to buy or sell overnight funds, has been at 0.25% since December 15, 2008, and is expected to remain there into 2015. The Prime rate typically moves in tandem with the Federal funds rate and similarly has not moved from its historical low of 3.25% since December of 2008. In addition to the current interest rate cycle being the lowest in U.S. history, it has also remained at the bottom far longer than any other rate cycle.

The fact that the Federal funds rate and the Prime rate have remained at these very low levels for over five years has had offsetting positive and negative impacts to the Corporation's NII; however, the long-term trend has been lower NII and margin. The decrease in the Federal funds rate has reduced the cost of funds on overnight borrowings and allowed lower interest rates paid on deposits, reducing the Corporation's interest expense, while the decrease in the Prime rate has reduced the yield on the Corporation's Prime-based loans. The Corporation's fixed rate loans do not reprice as rates change; however, with the steep decline in interest rates and a prolonged period with lower market rates, more customers have refinanced into lower fixed rate loans or moved into Prime-based loans. Due to heightened competitive pressures for the limited number of loan deals available, the Corporation has seen a decline in loan yields over the past few years. However, significant loan growth occurred in the last half of 2013, primarily from agricultural related loans. This resulted in higher average loan balances going into 2014, which acted to offset the declining yields. Additionally, yields on the Corporation's securities had declined during the first half of 2014 as mid-term and longer term interest rates made a gradual decline. The 2014 declines in U.S. Treasury rates caused mortgage prepayments of principal to increase which in turn causes an increase in amortization on MBS and CMO securities purchased at a premium. This has a significant impact on both the yield and weighted average life of these securities. The faster amortization reduces the yield on the instrument; however the length or duration of the security is shorter. Further declines in loan and securities yields caused the margin for the third quarter of 2014 to be lower than the margin for the first and second quarters of 2014. Should market interest rates increase going forward the mortgage principal prepayments would be expected to slow, as well as the amortization on these securities. This would increase the yield on these securities which would be beneficial to the Corporation's margin, however the other impact would be a lengthening of the average life of the security.

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Short-term interest rates have remained very low over the past five years as a result of the economic recession and slow recovery. As of September 30, 2014, there was approximately 225 basis points of slope between the overnight rate of 0.25% and the 10-year U.S. Treasury around 2.50%. This represents a typical positive-sloped curve from an historical perspective. However, the slope of the yield curve was more favorable at the end of 2013 with 275 basis points of slope between the overnight rate and the 10-year rate. The positive slope of the yield curve has fluctuated many times in the past few years with the overnight rates remaining the same. During the third quarter of 2013, the 10-year U.S. Treasury reached a high of 2.98%, compared to a high of 2.65% during the third quarter of 2014. Similarly, the 10-year U.S. Treasury was as low as 2.48% in the third quarter of 2013, and 2.34% in the third quarter of 2014.

Management is closely focused on the direction of mid-term and long-term rates as these rates can change well ahead of any Federal Reserve action, and they influence the pricing of the Corporation's interest-earning assets. There generally are offsetting impacts of market interest rate changes to the Corporation's Income Statement and Balance Sheet. Higher longer-term interest rates bring higher reinvestment rates for securities and higher loan rates, which benefits NII. However, higher long-term interest rates would also cause devaluation of the Corporation's securities portfolio, which needs to be marked to fair market value. This also makes it more difficult to sell securities at gains, which management has been actively doing while rates are lower. In addition to the impact on NII and securities gains, a significant rise in mid-term or long-term rates would have a large negative impact on the Corporation's capital. The impact on the Corporation's capital is discussed later in the Stockholders' Equity section under Financial Condition.

On the liability side of the balance sheet, the Corporation's deposits and borrowings generally price off overnight funds and the shorter U.S. Treasury rates. The very low short-term rates permitted management to continue to reduce the overall cost of funds during 2013 and into 2014. Typically, deposits and borrowings are priced off the one-year to five-year U.S. Treasury rates. These rates have also remained very low allowing management to continue to reprice time deposits and borrowings to lower levels.

While management prices the vast majority of liabilities off very low short-term rates, the Corporation's loans and securities are priced off the higher 5-year and 10-year U.S. Treasury rates. As a result, the Corporation benefits from more slope in the U.S. Treasury curve. Additional slope provides higher yields for the Corporation's assets relative to funding costs and therefore increases the net interest margin. Although long-term Treasury rates have increased significantly since early in 2013, management currently anticipates that the overnight interest rate and Prime rate will remain at these historically low levels through the remainder of 2014 and into 2015 because of the current economic conditions. It is also likely that the 10-year U.S. Treasury yield will trade in a higher range than early 2013, but will still remain low based on historical standards. Recent global concerns have driven longer-term Treasury rates down subsequent to September 30, 2014, but still above the lowest levels experienced in early 2013. The 10-year U.S. Treasury yield recently dipped down to below 2.00% on an intraday low on October 16, 2014, and more recently rebounded to approximately 2.25%. This has caused a narrowing of the spread between the overnight rate and the 10-year U.S. Treasury to 200 basis points. Unchanged, the recently reduced slope in the yield curve will cause the Corporation's margin to decline further, as most reinvestment in assets will occur at lower yields. The recent declines

in U.S. Treasury rates are highly influenced by global concerns. Management expects this to be a short-term event with longer-term U.S. Treasury rates likely to increase over the remainder of the fourth quarter of 2014 and into 2015. This would provide more slope on the yield curve and increase the yields available on new loans or securities.

The prolonged period with a Prime rate of 3.25% has caused the yield on the Corporation's loan portfolio to decline over a period of years. The longer the Prime Rate remained at 3.25%, the more opportunity retail and business customers had to convert their higher fixed rate loans to the lower Prime-based rate. Additionally, due to a highly competitive market for new loan deals, achieving higher yields on new business has been a challenge. Management anticipates that loan yields will increase with further improvements in the economy. This would support more loan growth. A better economy would likely coincide with higher mid-term and long-term rates as the Federal Reserve would continue to pull back on long-term asset purchases.

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The Corporation's margin was 3.02% for the third quarter of 2014, a sixteen basis-point decline from the 3.18% for the third quarter of 2013. For the year-to-date period, the Corporation's margin was 3.11%, a 5 basis-point decrease from the 3.16% for the nine months ended September 30, 2013. Although loan growth is occurring, it has been a challenge to increase loan pricing to the point where it is contributing to an increase in overall asset yield. As cost of funds savings become harder to achieve, the only way to materially increase net interest margin going forward will be through increases in asset yield. This was a challenge in the third quarter of 2014, and will likely remain a challenge in the foreseeable future. Any improvement in asset yields would be dependent on mid-term and longer-term interest rates increasing. This would assist with increased loan pricing and higher securities yields as a result of reduced amortization and higher yields being available at time of purchase.

For the third quarter of 2014, the Corporation's NII on an FTE basis increased by $38,000, or 0.6%, compared to the same period in 2013. For the nine months ended September 30, 2014, the Corporation's NII on an FTE basis increased by $628,000, or 3.6%, compared to the nine months ended September 30, 2013.

As shown on the tables that follow, interest income, on an FTE basis for the quarter ended September 30, 2014, decreased by $129,000, or 1.8%, and interest expense decreased by $167,000, or 12.6%, compared to the same period in 2013. For the nine months ended September 30, 2014, on an FTE basis, interest income increased by $117,000, or 0.5%, and interest expense decreased by $511,000, or 12.5%, compared to the nine months ended September 30, 2013.

The following tables show a more detailed analysis of net interest income on an FTE basis with all the major elements of the Corporation's consolidated balance sheets, which consists of interest earning and non-interest earning assets, and interest bearing and non-interest bearing liabilities. Additionally, the analysis provides the net interest spread and the net yield on interest earning assets. The net interest spread is the difference between the yield on interest earning assets and the rate paid on interest bearing liabilities. A deficiency of the net interest spread is that it does not give credit for the non-interest bearing funds and capital used to fund a portion of the total interest earning assets. For this reason, management emphasizes the net yield on interest earning assets, also referred to as the net interest margin (NIM). The NIM is calculated by dividing net interest income on an FTE basis into total average interest earning assets. NIM is generally the benchmark used by analysts to measure how efficiently a bank generates net interest income. For example, a financial institution with a NIM of 3.50% would be able to use fewer interest-earning assets and still achieve the same level of net interest income as a financial institution with a NIM of 3.25%.

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COMPARATIVE AVERAGE BALANCE SHEETS AND NET INTEREST INCOME

(DOLLARS IN THOUSANDS)

	For the Three Months Ended September 30,					
	2014			2013		
	Average Balance $	Interest $	(c) Annualized Yield/Rate %	Average Balance $	Interest $	(c) Annualized Yield/Rate %
ASSETS						
Interest earning assets:						
Federal funds sold and interest on deposits at other banks	22,928	17	0.30	19,674	18	0.36
Securities available for sale:						
Taxable	210,338	963	1.83	193,895	1,036	2.14
Tax-exempt	103,396	1,236	4.78	105,290	1,365	5.18
Total securities (d)	313,734	2,199	2.80	299,185	2,401	3.21
Loans (a)	454,254	4,906	4.31	428,886	4,862	4.53
Regulatory stock	4,119	42	4.11	3,791	12	1.24
Total interest earning assets	795,035	7,164	3.60	751,536	7,293	3.88
Non-interest earning assets (d)	56,304			50,411		
Total assets	851,339			801,947		
LIABILITIES & STOCKHOLDERS' EQUITY						
Interest bearing liabilities:						
Demand deposits	155,243	71	0.18	138,529	63	0.18
Savings deposits	129,038	17	0.05	120,227	17	0.06
Time deposits	215,950	689	1.27	220,948	773	1.39
Borrowed funds	71,433	378	2.10	68,318	469	2.72
Total interest bearing liabilities	571,664	1,155	0.80	548,022	1,322	0.96
Non-interest bearing liabilities:						
Demand deposits	186,677			168,239		
Other	3,051			3,206		

Total liabilities	761,392			719,467		
Stockholders' equity	89,947			82,480		
Total liabilities & stockholders' equity	851,339			801,947		
Net interest income (FTE)		6,009			5,971	
Net interest spread (b)			2.80			2.92
Effect of non-interest bearing funds			0.22			0.26
Net yield on interest earning assets (c)			3.02			3.18

(a) Includes balances of nonaccrual loans and the recognition of any related interest income. The quarter-to-date average balances include net deferred loan costs of $415,000 as of September 30, 2014, and $228,000 as of September 30, 2013. Such fees and costs recognized through income and included in the interest amounts totaled ($37,000) in 2014, and ($21,000) in 2013.

(b) Net interest spread is the arithmetic difference between the yield on interest earning assets and the rate paid on interest bearing liabilities.

(c) Net yield, also referred to as net interest margin, is computed by dividing net interest income (FTE) by total interest earning assets.

(d) Securities recorded at amortized cost. Unrealized holding gains and losses are included in non-interest earning assets.

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COMPARATIVE AVERAGE BALANCE SHEETS AND NET INTEREST INCOME

(DOLLARS IN THOUSANDS)

	For the Nine Months Ended September 30,					
	2014			2013		
	Average Balance $	Interest $	(c) Annualized Yield/Rate %	Average Balance $	Interest $	(c) Annualized Yield/Rate %
ASSETS						
Interest earning assets:						
Federal funds sold and interest on deposits at other banks	19,581	44	0.30	21,224	55	0.35
Securities available for sale:						
Taxable	204,620	3,231	2.11	192,591	2,864	1.98
Tax-exempt	102,961	3,807	4.93	105,293	4,242	5.37
Total securities (d)	307,581	7,038	3.05	297,884	7,106	3.18
Loans (a)	449,081	14,599	4.34	420,370	14,507	4.60
Regulatory stock	3,887	127	4.37	3,958	23	0.77
Total interest earning assets	780,130	21,808	3.73	743,436	21,691	3.89
Non-interest earning assets (d)	54,474			55,926		
Total assets	834,604			799,362		
LIABILITIES & STOCKHOLDERS' EQUITY						
Interest bearing liabilities:						
Demand deposits	149,354	199	0.18	136,396	191	0.19
Savings deposits	126,990	51	0.05	117,989	50	0.06
Time deposits	215,727	2,093	1.30	223,429	2,410	1.44
Borrowed funds	71,589	1,246	2.33	69,249	1,449	2.80
Total interest bearing liabilities	563,660	3,589	0.85	547,063	4,100	1.00
Non-interest bearing liabilities:						
Demand deposits	179,934			161,704		
Other	3,198			3,477		

Total liabilities	746,792			712,244		
Stockholders' equity	87,812			87,118		
Total liabilities & stockholders' equity	834,604			799,362		
Net interest income (FTE)		18,219			17,591	
Net interest spread (b)			2.88			2.89
Effect of non-interest bearing funds			0.23			0.27
Net yield on interest earning assets (c)			3.11			3.16

(a) Includes balances of nonaccrual loans and the recognition of any related interest income. The year-to-date average balances include net deferred loan costs of $387,000 as of September 30, 2014, and $228,000 as of September 30, 2013. Such fees and costs recognized through income and included in the interest amounts totaled ($95,000) in 2014, and ($55,000) in 2013.

(b) Net interest spread is the arithmetic difference between the yield on interest earning assets and the rate paid on interest bearing liabilities.

(c) Net yield, also referred to as net interest margin, is computed by dividing net interest income (FTE) by total interest earning assets.

(d) Securities recorded at amortized cost. Unrealized holding gains and losses are included in non-interest earning assets.

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Loan yields were at historically low levels during 2013 and during the nine months ended September 30, 2014, due to the extended low-rate environment as well as extremely competitive pricing for the limited number of quality loan opportunities in the market. The Corporation’s loan yield decreased 22 basis points in the third quarter of 2014 compared to the third quarter of 2013, and decreased 26 basis points for the first nine months of 2014 compared to the same period in 2013. It is anticipated that these yields will improve slightly in the coming months as the economy improves and loan demand increases, reducing pricing pressures and intense competition for loans. Despite the lower yields, the growth in the loan portfolio resulted in interest income on loans increasing $44,000, or 0.9%, for the third quarter of 2014 compared to the third quarter of 2013. For the nine months ended September 30, 2014, the Corporation’s interest income on loans increased $92,000, or 0.6%, compared to the same period in 2013.

Loan pricing was a challenge in 2013, and continues to be throughout 2014 as a result of intense competition resulting in fixed-rate loans being priced at very low levels and variable-rate loans priced at the Prime rate. The Prime rate is below typical fixed-rate business and commercial loans, which generally range between 3.50% and 6.00%, depending on term and credit risk. Management is able to price customers with higher levels of credit risk at Prime plus pricing but these rates are still generally below the fixed rate loan-pricing levels. Additionally, with the strong improvement to the credit quality of the Corporation’s loan portfolio there are fewer opportunities to price more credit risk into the loan rates. While Prime-based loans will aid the Corporation when interest rates rise, any increase in Prime-based loans will generally cause the Corporation’s average loan yield to decrease. The Asset Liability Committee (ALCO) carefully monitors the NIM because it indicates trends in net interest income, the Corporation’s largest source of revenue. For more information on the plans and strategies in place to protect the NIM and moderate the impact of rising rates, please refer to Item 7A. Quantitative and Qualitative Disclosures about Market Risk.

Earnings and yields on the Corporation’s securities declined by 41 basis points for the third quarter of 2014 compared to the third quarter of 2013. For the year-to-date period ended September 30, 2014, the yield on the securities portfolio decreased by 13 basis points compared to the same period in 2013. The Corporation’s securities portfolio consists of nearly all fixed income debt instruments. In the last half of 2013 and into 2014, when mid and long-term Treasury rates had increased, the Corporation was able to begin investing in the securities portfolio at slightly higher yields than had been available in the previous years. The Corporation’s taxable securities experienced a 13 basis-point increase in yield for the nine months ended September 30, 2014, compared to the same period in 2013. Meanwhile, pricing became tighter on tax-exempt securities where yields decreased by 40 basis points for the three months ended September 30, 2014, and 44 basis points for the nine months ended September 30, 2014, compared to the same periods in 2013. Spreads on tax-free municipal bonds tightened as the credit environment improved. Previously, the spreads on all municipal bonds were at highs affording better yields at purchase. Subsequent to September 30, 2014, but prior to the filing of this report, yields on new securities has been even more of a challenge with low Treasury rates resulting in few opportunities within the securities portfolio.

In the current rate environment with short-term rates extremely low and with small rate differences for longer-term deposits, the consumer is electing to stay short and maintain funds in accessible deposit instruments. As a result, the customer prefers keeping balances in both non-interest and interest bearing checking products and savings accounts. In addition to the consumer staying liquid with their available funds, there has been a general trend of funds flowing

from time deposit accounts into both non-interest checking, NOW and savings accounts. The average balance of the Corporation's interest bearing liabilities increased during the nine months ended September 30, 2014. The average balance of time deposits declined during this period compared to 2013, but the other areas of NOW, MMDA, and savings grew sufficiently enough to compensate for the decline in time deposits, causing total interest bearing funds to increase. However, with more of the interest bearing funds in the form of NOW, MMDA, and savings accounts the average interest rate paid on these instruments is less than what is paid on time deposits, which will result in less interest expense.

Interest expense on deposits declined by $76,000 for the three months ended September 30, 2014, and $308,000 for the nine months ended September 30, 2014, compared to the same periods in 2013. Demand and savings deposits reprice in entirety whenever the offering rates are changed. This allows management to reduce interest costs rapidly; however, it becomes difficult to continue to gain cost savings once offering rates decline to these historically low levels. The annualized rate on interest bearing demand accounts was 0.18% for the three and nine-month periods ended September 30, 2014, compared to 0.18% for the prior year's third quarter and 0.19% for the year-to-date period. The scope of further reductions in dollar amount of interest expense is very limited since rates cannot be reduced much lower. For the first nine months of 2014, the average balances of interest bearing demand deposits increased by $13.0 million, or 9.5%, over the same period in 2013, while the average balance of savings accounts increased by $9.0 million, or 7.6%. This increase in balances of lower cost accounts has helped to reduce the Corporation's overall interest expense in 2014 compared to 2013.

Time deposits reprice over time according to their maturity schedule. This enables management to both reduce and increase rates slowly over time. During 2013 and through the first nine months of 2014, time deposit balances decreased. The decrease can be attributed to the lowest rates paid historically on time deposits, which has caused the differential between time deposit rates and rates on non-maturing deposits to be minimal. As a result, customers have elected to keep more of their funds in non-maturity deposits and less funds in time deposits. Because time deposits are the most expensive deposit product for the Corporation and the largest dollar expense from a funding standpoint, the reduction in time deposits, along with the increases in interest-bearing checking, savings, and non-interest bearing checking, has allowed the Corporation to achieve a lower cost and more balanced deposit funding position. The Corporation was able to reduce interest expense on time deposits by $84,000, or 10.9%, for the third quarter of 2014, compared to the same period in 2013, and $317,000, or 13.2%, for the nine months ended September 30, 2014, compared to the same period in 2013. Average balances decreased by $5.0 million, or 2.3%, and $7.7 million, or 3.4%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013, respectively. The average annualized interest rate paid on time deposits decreased by 12 basis points for the three-month period and 14 basis points for the nine-month period when comparing both years.

The Corporation historically uses both short-term and long-term borrowings to supplement liquidity generated by deposit growth. Average short-term advances of $295,000 were utilized in the first nine months of 2013, while average short-term advances of $5,500,000 were utilized in the first nine months of 2014. Management has used long-term borrowings as part of an asset liability strategy to lengthen liabilities rather than as a source of liquidity. Average total borrowings increased by $3.1 million, or 4.6%, in the third quarter of 2014 compared to the same quarter in 2013, and $2.3 million, or 3.4%, for the nine months ended September 30, 2014, compared to the same period in 2013. Interest expense was $90,000, or 19.2% lower, for the three-month period and $203,000, or 14.0% lower, for the nine-month period when comparing 2014 to 2013.

The NIM was 3.02% for the third quarter of 2014, and 3.11% for the nine months ended September 30, 2014, compared to 3.18% and 3.16% for the same periods in 2013. For the quarter ended September 30, 2014, the net interest spread decreased twelve basis points to 2.80%, from 2.92% for the same period in 2013. For the nine-month period ended September 30, 2014, the net interest spread decreased one basis point to 2.88%, from 2.89% for the same period in 2013. The effect of non-interest bearing funds dropped four basis points for the three and nine-month periods compared to the prior year. The effect of non-interest bearing funds refers to the benefit gained from deposits on which the Corporation does not pay interest. As rates go lower, the benefit of non-interest bearing deposits is reduced because there is less difference between non-interest bearing funds and interest bearing liabilities. For example, if a savings account with $10,000 earns 1%, the benefit for $10,000 of non-interest bearing deposits is equivalent to $100; but if the savings rate is reduced to 0.20%, then the benefit of the non-interest bearing funds is only $20. This assumes dollar-for-dollar replacement, which is not realistic, but demonstrates the way the lower cost of funds affects the benefit to non-interest bearing deposits.

The Asset Liability Committee (ALCO) carefully monitors the NIM because it indicates trends in net interest income, the Corporation's largest source of revenue. For more information on the plans and strategies in place to protect the NIM and moderate the impact of rising rates, please see Quantitative and Qualitative Disclosures about Market Risk.

Provision for Loan Losses

The allowance for loan losses (ALLL) provides for losses inherent in the loan portfolio as determined by a quarterly analysis and calculation of various factors related to the loan portfolio. The amount of the provision reflects the adjustment management determines necessary to ensure the ALLL is adequate to cover any losses inherent in the loan portfolio. The Corporation recorded no provision for the three months ended September 30, 2014 or 2013, and recorded credit provisions of $300,000 and $150,000 for the nine months ended September 30, 2014 and 2013, respectively. The analysis of the ALLL takes into consideration, among other things, the following factors:

- levels and trends in delinquencies, nonaccruals, charge-offs and recoveries,
- trends within the loan portfolio,
- changes in lending policies and procedures,
- experience of lending personnel and management oversight,

- national and local economic trends,
- concentrations of credit,
- external factors such as legal and regulatory requirements,
- changes in the quality of loan review and board oversight,
- changes in the value of underlying collateral.

Credit provisions were recorded in 2014 and 2013 due to the following factors:

- Low levels of delinquent and non-performing loans
- Lower levels of classified loans
- Low net charge-offs/recoveries

Prior to 2012, the annual provision expense was at increased levels to account for difficult economic conditions that had an impact on the financial health of the Corporation's borrowers and a direct impact on asset quality. Throughout 2012, 2013, and into 2014, after analysis of the factors listed above, the allowance for loan loss calculation resulted in a reduction of the provision because of significant improvements in the loan portfolio related to delinquent, non-performing, and classified loans. Management closely tracks delinquent, non-performing, and classified loans as a percentage of capital and of the loan portfolio.

As of September 30, 2014, total delinquencies represented 0.65% of total loans, compared to 0.76% as of September 30, 2013. These ratios are extremely low compared to local and national peer groups. The vast majority of the Corporation's loan customers have remained very steadfast in making their loan payments and avoiding delinquency, even during challenging economic conditions. The delinquency ratios speak to the long-term health, conservative nature, and, importantly, the character of the Corporation's customers and lending practices. Classified loans are primarily determined by loan-to-value and debt-to-income ratios. The prolonged economic downturn, including devaluation of residential and commercial real estate, had stressed these ratios in past periods. Valuations have recently shown improvements and the levels of classified loans have declined significantly, well below levels experienced in 2012 and 2011. The delinquency and classified loan information is utilized in the quarterly allowance for loan loss (ALLL) calculation, which directly affects the provision expense. A sharp increase or decrease in delinquencies and/or classified loans during the quarter would be cause for management to increase or decrease the provision expense. The level of actual charge-offs relative to the amount of recoveries can have a significant impact on the provision. Management was in the favorable position of having more recoveries than charge-offs in the first nine months of 2014. This alone acted to increase the ALLL by $49,000 and was partially responsible for the need to take a $300,000 credit provision in the first nine months of 2014.

Generally, management will evaluate and adjust, if necessary, the provision expense each quarter based upon completion of the quarterly ALLL calculation. Future provision amounts will depend on the amount of loan growth achieved versus levels of delinquent, non-performing, and classified loans.

In addition to the above, provision expense is impacted by three major components that are all included in the quarterly calculation of the ALLL. First, specific allocations are made for any loans where management has determined an exposure that needs to be provided for. These specific allocations are reviewed each quarter to determine if adjustments need to be made. It is common for specific allocations to be reduced as additional principal payments are made, so while some specific allocations are being added, others are being reduced. Second, management provides for estimated losses on pools of similar loans based on historical loss experience. Finally, management utilizes qualitative factors every quarter to adjust historical loss experience to take into consideration the current trends in loan volume, delinquencies, charge-offs, changes in lending practices, and the quality of the Corporation's underwriting, credit analysis, lending staff, and Board oversight. National and local economic trends and conditions are helpful to determine the amount of loan loss allowance the Corporation should be carrying on the various types of loans. Management evaluates and adjusts, if necessary, the qualitative factors on a quarterly basis.

In 2014, factors related to dairy farming and non-dairy agriculture have improved reflecting the improved outlook for the industry. Due to the focus on growing the Corporation's residential mortgage area, residential real estate adjustment factors were increased during the first nine months of 2014. Also affecting the allowance calculation, there was only one business loan charge-off and no agriculture loan charge-offs in the past year, reducing the three-year weighted average charge-off ratio used to calculate the required reserves. This, combined with the other factor adjustments, caused a lower required reserve amount. The periodic adjustment of qualitative factors allows the Corporation's historical loss experience to be continually brought current to more accurately reflect estimated credit losses, based on the current environment.

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Management monitors the allowance as a percentage of total loans. Because of the credit provisions recorded in 2013 and in the first nine months of 2014, the percentage of the allowance to total loans has decreased since September 30, 2013 and December 31, 2013, but remains comparable with the peer group. As of September 30, 2014, the allowance as a percentage of total loans was 1.52%, down from 1.65% at December 31, 2013, and 1.67% at September 30, 2013. Management continues to evaluate the allowance for loan losses in relation to the size of the loan portfolio and changes to the segments within the loan portfolio and their associated credit risk. Management believes the allowance for loan losses is adequate to provide for future loan losses based on the current portfolio and the current economic environment. More detail is provided under Allowance for Loan Losses in the Financial Condition section that follows.

Other Income

Other income for the third quarter of 2014 was $2,275,000, an increase of $336,000, or 17.3%, compared to the $1,939,000 earned during the third quarter of 2013. For the year-to-date period ended September 30, 2014, other income totaled $6,623,000, a decrease of $48,000, or 0.7%, compared to the same period in 2013. The following tables detail the categories that comprise other income.

OTHER INCOME

(DOLLARS IN THOUSANDS)

	Three Months Ended September 30,		Increase (Decrease)	
	2014	2013		
	$	$	$	%
Trust and investment services	309	273	36	13.2
Service charges on deposit accounts	321	308	13	4.2
Other service charges and fees	186	153	33	21.6
Commissions	507	491	16	3.3
Gains on securities transactions, net	624	537	87	16.2
Impairment losses on securities	—	(44)	44	(100.0)
Gains on sale of mortgages	120	20	100	500.0
Earnings on bank owned life insurance	163	162	1	0.6
Other miscellaneous income	45	39	6	15.4
Total other income	2,275	1,939	336	17.3

OTHER INCOME

(DOLLARS IN THOUSANDS)

	Nine Months Ended September 30,		Increase (Decrease)	
	2014	2013		
	$	$	$	%
Trust and investment services	959	883	76	8.6
Service charges on deposit accounts	880	827	53	6.4
Other service charges and fees	441	473	(32)	(6.8)
Commissions	1,467	1,467	—	0.0
Gains on securities transactions, net	1,891	2,216	(325)	(14.7)
Impairment losses on securities	(22)	(157)	135	(86.0)
Gains on sale of mortgages	250	208	42	20.2
Earnings on bank owned life insurance	477	480	(3)	(0.6)
Other miscellaneous income	280	274	6	2.2
Total other income	6,623	6,671	(48)	(0.7)

Trust and investment services income increased $36,000 and $76,000, or 13.2% and 8.6%, for the three and nine months ended September 30, 2014, compared to the same periods last year. This revenue consists of income from traditional trust services and income from alternative investment services provided through a third party. In the third quarter of 2014, traditional trust income increased by $24,000, or 12.5%, while income from alternative investments increased by $12,000, or 15.0%, compared to the third quarter of 2013. For the nine months ended September 30, 2014, traditional trust services income increased by $69,000, or 11.6%, while income from alternative investment services increased by $8,000, or 2.6%, compared to the same period in 2013. Trust income was up for both periods as a result of both higher fees and higher trust valuations. Investment services income is dependent on new investment activity derived from the period. Both third quarter and year-to-date investment services activity was up as of September 30, 2014, compared to the prior year. The trust and investment services area continues to be an area of strategic focus for the Corporation. Management believes there is a great need for retirement, estate, small business planning, and personal investment services in the Corporation's service area. Management also sees these services as being a necessary part of a comprehensive line of financial solutions across the organization.

Service charges on deposit accounts increased by $13,000, or 4.2%, for the three months ended September 30, 2014, and $53,000, or 6.4%, for the nine months ended September 30, 2014, compared to the same periods in 2013. Overdraft service charges are the largest component of this category and comprised approximately 83% and 82% of the total deposit service charges for the three and nine months ended September 30, 2014. Total overdraft fees increased by $7,000, or 2.7%, and $26,000, or 3.7%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013. This increase was primarily driven by a per item fee increase implemented in February of 2013. Bonus checking service charges increased by $3,000, or 14.9%, and $15,000, or 36.4%, for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013, also a result of a per item fee increase in 2013. Service charges on savings accounts increased by $4,000, or 52.3%, and $10,000, or 50.8%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013, due to an increase in the fee amounts in the first quarter of 2013. Most of the other service charge areas showed minimal increases or decreases from the prior year.

Other service charges and fees increased by $33,000, or 21.6%, and decreased by $32,000, or 6.8%, for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. The quarterly increase is primarily due to an increase in letters of credit fees. These fees increased by $26,000 and $40,000 for the three and nine months ended September 30, 2014, compared to the same periods in 2013. Similarly, mortgage origination fees increased by $20,000 and $4,000 for the three and nine months ended September 30, 2014, compared to the same periods in 2013. Growth in the mortgage area continues to be a primary focus for the Corporation. Loan administration fees increased by $24,000 for the three-month period and $37,000 for the nine-month period ended September 30, 2014, compared to the same periods in the prior year. An increase in fees in the second quarter of 2014 was responsible for this increase. Partially offsetting these increases for the quarter-to-date period and more than offsetting them for the year-to-date period, loan modification fees decreased by $34,000 and $130,000, for the three and nine-month periods ended September 30, 2014, compared to the same periods in 2013 due to heightened commercial loan modification in 2013 with little activity in 2014. Various other fee income categories increased or decreased slightly.

For the three months ended September 30, 2014, $624,000 of gains on securities transactions excluding impairment were recorded compared to $537,000 for the same period in 2013. For the nine months ended September 30, 2014, $1,891,000 of gains on securities transactions were recorded compared to $2,216,000 for the nine months ended September 30, 2013. Gains or losses on securities transactions fluctuate based on market opportunities to take gains and reposition the securities portfolio to improve long-term earnings, or as part of management's asset liability goals to improve liquidity or reduce interest rate risk or fair value risk. Gains or losses on securities fluctuate significantly based on market pricing and the volume of security sales. Generally, the lower U.S. Treasury yields go, the more management will be motivated to pursue taking gains from the sale of securities. However, these market opportunities are evaluated subject to the Corporation's other asset liability measurements and goals. The yield curve in the first nine months of 2013 provided opportunities to take significant gains out of the portfolio. Similar market opportunities were still available during the first nine months of 2014, but not to the same degree or amount as the prior year, although the third quarter gains in 2014 were stronger than 2013.

While there were no impairment losses for the three months ended September 30, 2014, there were impairment losses on securities of $44,000 for the three months ended September 30, 2013. For the year-to-date periods, impairment losses were $22,000 in 2014, compared to $157,000 in 2013. Impairment losses occur when securities are written down to a lower value based on anticipated credit losses. The impairment losses recorded in 2014 and 2013 were related to private collateralized mortgage obligations, which were all sold in the first half of 2014. Further information on securities and other than temporary impairment is provided in the Securities Available for Sale section, under Financial Condition, in this filing.

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Gains on the sale of mortgages were $120,000 for the three-month period ended September 30, 2014, compared to $20,000 for the same period in 2013, a $100,000 increase. Gains on the sale of mortgages for the nine months ended September 30, 2014, increased by $42,000, or 20.2%, compared to the same period in 2013. Secondary mortgage financing activity drives the gains on the sale of mortgages, and this activity was stronger in the first half of 2013, but then slowed throughout the third quarter. Conversely, in 2014, activity was slower in the first half of the year, but picked up significantly in the third quarter resulting in the large quarterly increase in income. Management anticipates that gains should continue to increase throughout the fourth quarter of 2014 with an increased focus and resources deployed to grow the Corporation's mortgage origination activity.

Operating Expenses

Operating expenses for the third quarter of 2014 were $5,767,000, an increase of $420,000, or 7.9%, compared to the $5,347,000 for the third quarter of 2013. For the year-to-date period ended September 30, 2014, operating expenses totaled $17,354,000, an increase of $1,155,000, or 7.1%, compared to the same period in 2013. The following tables provide details of the Corporation's operating expenses for the three and nine-month periods ended September 30, 2014, compared to the same periods in 2013.

OPERATING EXPENSES

(DOLLARS IN THOUSANDS)

	Three Months Ended September 30,		Increase (Decrease)	
	2014	2013		
	$	$	$	%
Salaries and employee benefits	3,517	3,193	324	10.1
Occupancy expenses	476	462	14	3.0
Equipment expenses	287	248	39	15.7
Advertising & marketing expenses	95	68	27	39.7
Computer software & data processing expenses	393	386	7	1.8
Bank shares tax	170	215	(45)	(20.9)
Professional services	311	297	14	4.7
Other operating expenses	518	478	40	8.4
Total Operating Expenses	5,767	5,347	420	7.9

OPERATING EXPENSES

(DOLLARS IN THOUSANDS)

	Nine Months Ended September 30,		Increase (Decrease)	
	2014	2013		
	$	$	$	%
Salaries and employee benefits	10,428	9,545	883	9.3
Occupancy expenses	1,451	1,303	148	11.4
Equipment expenses	815	716	99	13.8
Advertising & marketing expenses	350	307	43	14.0
Computer software & data processing expenses	1,188	1,193	(5)	(0.4)
Bank shares tax	536	644	(108)	(16.8)
Professional services	991	925	66	7.1
Other operating expenses	1,595	1,566	29	1.9
Total Operating Expenses	17,354	16,199	1,155	7.1

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Salaries and employee benefits are the largest category of operating expenses. In general, they comprise 60% of the Corporation's total operating expenses. For the three months ended September 30, 2014, salaries and benefits increased $324,000, or 10.1%, from the same period in 2013. For the nine months ended September 30, 2014, salaries and benefits increased $883,000, or 9.3%, compared to the nine months ended September 30, 2013. Salaries increased by $261,000, or 10.9%, and employee benefits increased by $62,000, or 7.8%, for the three months ended September 30, 2014, compared to the same period in 2013. For the nine months ended September 30, 2014, salary expense increased by $685,000, or 9.7%, while employee benefits increased by $198,000, or 7.9%, compared to the nine months ended September 30, 2013. Salary and benefit expenses are growing primarily as a result of staff costs for the two new branch offices opened in 2013 as well as staff costs for the Corporation's growing mortgage division. Several additional positions are expected to be added in the mortgage division in the fourth quarter of 2014.

Occupancy expenses consist of the following:

- Depreciation of bank buildings
- Real estate taxes and property insurance
- Building lease expense
- Utilities
- Building repair and maintenance

Occupancy expenses increased $14,000, or 3.0%, and $148,000, or 11.4%, for the three and nine months ended September 30, 2014, compared to the same periods in the prior year. Building depreciation costs increased by $15,000, or 9.9%, and $48,000, or 10.7%, for the three and nine months ended September 30, 2014, compared to the same periods in the prior year primarily as a result of construction of a new branch office opened in 2013. The other branch office opened in 2013 was a leased building. Building repair and maintenance costs, which are smaller dollar expenses, decreased by $34,000, or 59.0%, and $23,000, or 22.0%, for the three and nine-month periods. Several large repairs at the Corporation's main headquarters in 2013 caused this decrease. Utilities costs did not change significantly for the quarterly period, but increased $23,000, or 5.1%, for the nine months ended September 30, 2014, compared to the same period in 2013. Higher utility costs were driven by abnormally cold winter weather in the first quarter of 2014. Other occupancy expenses increased $30,000, or 83.8%, and $87,000, or 82.6%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013. This was primarily due to higher snow removal costs from a harsh winter in 2014 compared to 2013, and higher lease expenses in the nine months ended September 30, 2014, compared to the same period in 2013 due to the lease of the Leola Branch as well as additional office space leased during 2014 in downtown Ephrata.

Equipment-related expenses increased by $39,000, or 15.7%, and $99,000, or 13.8%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013. This increase was primarily due to depreciation expenses, which increased $19,000, or 11.8%, and $71,000, or 16.1%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013, as a result of furniture and equipment at the two new additional branch offices. Additionally, expenses related to equipment service contracts increased by $24,000, or 44.0%, and

$53,000, or 31.6%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013.

Advertising and marketing expenses increased $27,000, or 39.7%, and $43,000, or 14.0%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013. These expenses can be further broken down into two categories, marketing expenses and public relations. The marketing expenses increased by $9,000, or 17.8%, and $26,000, or 11.8%, and the public relations expenses increased by $17,000, or 110.3%, and $17,000, or 18.6%, for the three and nine months ended September 30, 2014, respectively, compared to the same periods in 2013. Marketing expenses support the overall business strategies of the Corporation; therefore, the timing of these expenses is highly dependent upon the execution of those strategies.

Bank shares tax expense decreased $45,000, or 20.9%, for the three months ended September 30, 2014, and $108,000, or 16.8%, for the nine months ended September 30, 2014, compared to the same periods in 2013. The PA Bank Shares Tax formula was changed for 2014 resulting in a lower tax amount for the Corporation. Two main factors determine the amount of bank shares tax: the ending value of shareholders' equity and the ending value of tax-exempt U.S. obligations. The 2013 shares tax calculation formula utilized a rolling six-year average of taxable shares, which was the average shareholders' equity of the Bank less the average amount of exempt U.S. obligations held. The shares tax calculation in 2014 changed to using a period-end balance of shareholders' equity and a tax rate of 0.89% versus 1.25% in 2013 and prior years, resulting in a lower tax amount.

Professional services expense increased $14,000, or 4.7%, and $66,000, or 7.1%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013. These services include accounting and auditing fees, legal fees, loan review fees, and fees for other third-party services. Other outside services expense increased $15,000, or 11.6%, and $66,000, or 17.3%, for the three and nine months ended September 30, 2014, compared to the same periods in 2013, primarily due to increased costs from the Corporation's internet banking/bill pay software provider. Several other professional services expenses increased or decreased slightly making up the remainder of the variance.

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Income Taxes

The majority of the Corporation's income is taxed at a corporate rate of 34% for Federal income tax purposes. For the three and nine months ended September 30, 2014, the Corporation recorded Federal income tax expense of $337,000 and $1,083,000, compared to tax expense of $274,000 and $958,000 for the three and nine months ended September 30, 2013. The effective tax rate for the Corporation was 16.4% for the three months ended September 30, 2014, and 17.0% for the nine months ended September 30, 2014, compared to 13.6% and 14.7% for the same periods in 2013. The Corporation's effective tax rate has historically been maintained at low levels primarily due to a relatively high level of tax-free municipal bonds held in the securities portfolio. The fluctuation of the effective tax rate will occur as a result of total tax-free revenue as a percentage of total revenue.

Certain items of income are not subject to Federal income tax, such as tax-exempt interest income on loans and securities, and BOLI income; therefore, the effective income tax rate for the Corporation is lower than the stated tax rate. The effective tax rate is calculated by dividing the Corporation's provision for Federal income taxes on the Consolidated Statements of Income by the income before income taxes for the applicable period.

The Corporation is also subject to Pennsylvania Corporate Net Income Tax; however, the Corporation's Holding Company has very limited taxable corporate net income activities. The Corporation's wholly owned subsidiary, Ephrata National Bank, is subject to Pennsylvania Bank Shares Tax. Like Federal Corporate income tax, the Pennsylvania Bank Shares Tax is a significant expense for the Corporation. The Bank Shares Tax expense appears on the Corporation's Consolidated Statements of Income, under operating expenses.

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Financial Condition

Securities Available for Sale

The Corporation classifies all of its securities as available for sale and reports the portfolio at fair market value. As of September 30, 2014, the Corporation had $301.3 million of securities available for sale, which accounted for 35.4% of assets, compared to 37.0% as of December 31, 2013, and 35.3% as of September 30, 2013. Based on ending balances, the securities portfolio increased 7.3% from September 30, 2013, and 0.3% from December 31, 2013.

There was a sharp decline in the market valuation of the Corporation’s securities beginning in the second quarter of 2013 and continuing through the end of 2013. Since December 31, 2013, market valuations have improved, with an unrealized gain on the entire portfolio as of September 30, 2014. The decline in the second half of 2013 was a result of marked increases in mid-term and long-term interest rates that occurred on the heels of the Federal Reserve June 19, 2013 comments on the winding down of its $85 billion of bond purchases per month by later in 2013 and all together by mid-2014. This caused unsettling in the bond market with valuation declines. At the time of the remarks, the 10-year U.S. Treasury stood at a 2.20% yield. Within two weeks, the 10-year yield had risen to 2.60%. The 10-year U.S. Treasury stayed within a fairly narrow range in the second half of 2013 until December when it gradually rose to 3.00% by year end. The unrealized losses in the securities portfolio were at higher levels as of September 30, 2013, and December 31, 2013, as the result of higher Treasury rates.

Since December 31, 2013, the 10-year U.S. Treasury yield slowly declined to approximately 2.75% by March 31, 2014, close to 2.50% by June 30, 2014, and remained at 2.50% as of September 30, 2014. The lower Treasury rates have caused an improvement in market valuation, resulting in an unrealized gain of $1.0 million on the securities portfolio as of September 30, 2014, compared to unrealized losses of $6.0 million as of December 31, 2013, and $3.0 million as of September 30, 2013. Since longer term interest rates were impacted the most, the Corporation’s longest securities, obligations of states and political subdivisions, saw the most fluctuation in market valuation.

The table below summarizes the Corporation’s cost, unrealized gain or loss position, and fair value for each sector of the securities available for sale portfolio for the periods ended September 30, 2014, December 31, 2013, and September 30, 2013.

AMORTIZED COST AND FAIR VALUE OF SECURITIES HELD

(DOLLARS IN THOUSANDS)

September 30, 2014	Amortized Cost $	Net Unrealized Gains (Losses) $	Fair Value $
U.S. government agencies	37,702	(872)	36,830
U.S. agency mortgage-backed securities	46,485	251	46,736
U.S. agency collateralized mortgage obligations	59,309	(586)	58,723
Private collateralized mortgage obligations	—	—	—
Corporate bonds	53,053	(65)	52,988
Obligations of states and political subdivisions	98,363	2,294	100,657
Total debt securities	294,912	1,022	295,934
Marketable equity securities	5,376	(13)	5,363
Total securities available for sale	300,288	1,009	301,297