

119 Years of Hometown Banking

2012 Annual Report

### Our Mission

This Corporation was established as a "Hometown Bank" to provide a profit and to furnish the financial needs of its community, its people, and its businesses. We are in the financial services business, and no line of financial services under the law is beyond our charter as long as we are serving needs of businesses and families of our community

The primary mission of this Bank is to maximize earnings for its shareholders. We want to maximize earnings over the long term; however, we will sacrifice short-term earnings for higher future profits when it is feasible.

The Bank's most important assets are our customers and employees. Our products are designed to meet the needs of customers, our hours are set to meet the needs of customers and our employees are hired to meet the needs of our customers. High quality customer service is the true mission of this bank.

Without dedicated and responsible employees, it would be impossible for the Bank to be a responsible citizen of the community or to render the high quality service our customers deserve. This Bank is and will be a responsible employer. All Bank employees will be treated with dignity and respect. All will be given equal opportunity and a fair wage regardless of race, color, sex, or the presence of a protected disability

This Bank takes its citizenship duties seriously as a responsible citizen and a business leader of our community We will not knowingly take actions that are adverse to the best interest of our community, its businesses (including those in deprived neighborhoods), or its families (low income families)

### Dear Shareholders.

It is my pleasure to present the 2012 financial results for Muncy Bank Financial, Inc. This year marked the 119<sup>th</sup> year since a group of local businessmen saw the need to organize a second bank in the town of Muncy. They realized that to truly be successful, they must meet the financial needs of the residents and businesses in our local communities. This could only be accomplished by providing local ownership, local management, and local decision-making. That mindset has not changed since those humble and modest beginnings. Our accomplishments this year reaffirm our commitment to those principles which are solidified by our success, as Muncy Bank Financial, Inc. and its wholly owned subsidiary, The Muncy Bank and Trust Company, have again achieved record performance.

Net income increased \$524,453 or 12.15% from the prior year. Actual net earnings were \$4,841,682 or \$3.15 per share\*. In comparison, 2011 earnings, which were a previous record, were \$4,317,229 or \$2.84 per share\*. Our return on average assets (ROAA) increased from 1.48% in 2011 to 1.55% in 2012, and continues to exceed Pennsylvania's commercial banking averages of .80%.

Shareholders' equity increased 13.94% or \$4,179,584, ending the year at \$34,153,313. Our return on average equity (ROAE) was 15.1%, which is more than two times Pennsylvania's commercial banking averages of 7.6% for the same period. With this increase in equity, Muncy Bank Financial, Inc. increased dividends 13.43% from \$.67 per share\* in 2011 to \$.76 per share\* in 2012.

We continued to experience solid growth in our balance sheet during 2012. Deposits increased 7.65% or \$19,560,828 and total \$275,401,969. Assets increased 7.66% or \$22,972,381 and total \$322,975,097. In spite of the continuing sluggish economy, we increased our loan portfolio by 6.5% or \$14,835,730 ending 2012 at \$243,111,353. With our loan growth, we continued to maintain a quality loan portfolio, as our overall loan delinquency on December 31, 2012, was 1.11% of total loans outstanding. Additionally, we have continued to increase our allowance for loan loss, which totals \$3,925,296 on December 31, 2012, from \$3,469,360 the prior year. With this increase of \$455,936 for 2012, our loan loss reserve balance is 1.59% of our outstanding loan portfolio.

Additionally, we continue to sell loans on the secondary mortgage market, which are not included in our loan portfolio balances. During 2012, we sold \$4,078,736 in fixed rate mortgages, which add servicing income on a monthly basis. Today, we service \$15,445,754 in fixed rate loans on the secondary mortgage market.

As I mentioned in last years report, your Muncy Bank Financial, Inc. common stock increased in excess of 105% in the two years prior to 2012. With this increase in market value, our Board of Directors approved a 2-for-1 stock split on January 10, 2012, which was effective on February 15, 2012. Following our stock split in February, Muncy Bank Financial, Inc. common stock increased in value from \$27.50 per share and rose to approximately \$36.25 per share on December 31, 2012. This increase represents a 31.82% increase in market value for 2012. For comparison, the S & P 500 Index had a total return of 15.99% for 2012 and a 3-year total return of 10.79%.

While it is impossible to predict future yields and returns, it is very clear that investors today are looking for several key factors when analyzing bank stocks. Those factors include asset quality, adequate loan loss reserve allocations, excess capital positions, and the ability to grow through a variety of economic conditions. Muncy Bank Financial, Inc. has demonstrated a long history of out performing our peer institutions, through a variety of economic climates.

(\*adjusted for a 2-for-1 stock split on February 15<sup>th</sup>, 2012)

I am pleased to report the promotions of several individuals during 2012. Diane Jordan was promoted to our Hughesville Assistant Community Office Manager, Kimberly Wetherhold, Assistant Community Office Administrator, and Tricia Giazzon, our Montoursville Head Teller. All three individuals possess a strong desire to grow in their job knowledge, but also help our institution achieve our strategic goals and initiatives. Today we employ over 80 individuals who collectively have been the reason for our corporate success.

The Muncy Bank and Trust Company continues our long tradition of civic leadership through our corporate contributions. Just a few of our corporate gifts during 2012 include the Lycoming Chapter of the American Cancer Society, Muncy Borough Shade Tree Commission, Muncy Public Library, Muncy Valley Hospital Lawn Party, YMCA in both Muncy and Williamsport, Muncy Area Lions "Save the Park Fund", and The Vineyard Community Center. Additionally, we completed our two-year pledge of \$222,000 under the Educational Improvement Tax Credit (EITC), with \$44,400 donated to each of the five school districts in our market, which include Muncy, East Lycoming, Montgomery, Montoursville, and Warrior Run School Districts. These funds are to be used to help our local school districts with educational programs due to Pennsylvania state budget cuts. Additionally, our officers, directors, and employees donated their time and talents, as nearly 85% of our staff participated in a variety of civic and charitable activities during 2012.

I am pleased to report that The Muncy Bank and Trust Company again received the "Exceptional Performance Award" from Bauer Financial, Inc., Coral Gables, Florida. The five-star superior rating is based on the overall financial condition of the bank in terms of strength and stability and continues to be the only bank headquartered in Lycoming County to achieve this highest distinction.

It is with great pleasure to announce that Muncy Bank Financial, Inc. has continued to move up the ranking on the "Top 200 Community Bank List" in the United States as published by <u>U.S. Banker</u> magazine. In the May 2012 issue, Muncy Bank Financial, Inc. (OTCBB: MYBF) was ranked 30<sup>th</sup> on this prestigious list. This is the fourth consecutive year that the bank has been recognized and this years ranking is improved from last years ranking of 46<sup>th</sup>. This list includes all banks and thrifts with less that \$2 billion in assets as of December 31, 2011. In addition, the "Top 200 Community Bank List" ranks institutions based on a three-year average return on equity (ROE) for three years ending December 31, 2009, 2010, and 2011. It is estimated that 96% of the nation's 8000 banks have assets less than \$2 billion today.

Mary Kay Ash, American businesswoman and founder of Mary Kay Cosmetics, Inc., once said, "People are definitely a company's greatest asset. It doesn't make any difference whether the product is cars or cosmetics, a company is only as good as the people it keeps." That statement could not be more appropriate as our continued success year after year is the direct result of the tremendous contributions of our directors, officers, and employees. It is through their efforts that The Muncy Bank and Trust Company continues to make a difference for so many who live and work in our community. We continue this proud tradition of true community banking just as it began back in 1893. We thank you, our shareholders, for your continued support and confidence. We are truly excited about our future, and look forward to continuing to build your investment in our "Hometown Bank".

Thank you for your continued patronage.

Respectfully.

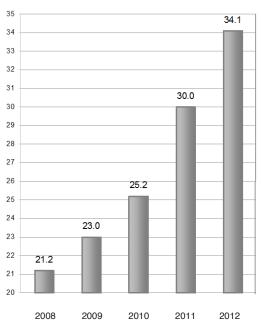
Daniel C. Berninger

President and Chief Executive Officer

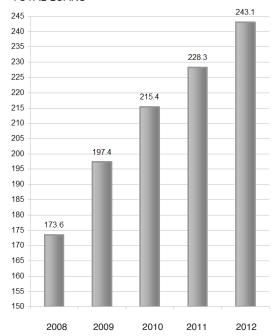
### FIVE YEAR FINANCIAL HIGHLIGHTS

(In Millions)

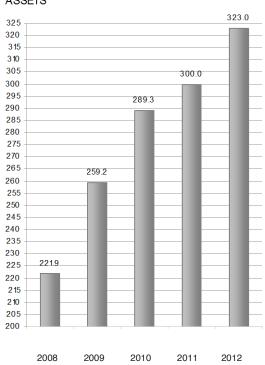
### SHAREHOLDERS EQUITY



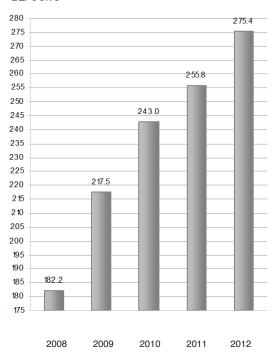
### **TOTAL LOANS**



### **ASSETS**



#### **DEPOSITS**



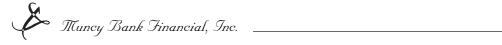
	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	2008
Net Income	\$ 4,841,682	\$ 4,317,229	\$ 3,070,944	\$ 2,550,784	\$ 2,305,859
Earnings Per Share	\$3.15*	\$2.84*	\$2.05*	\$1.72*	\$1.55*
Return on Average Assets	1.55%	1.48%	1.13%	1.09%	1.10%
Dividends Paid Per Share	\$ .76*	\$ .67*	\$ .60*	\$ .57*	\$ .55*

<sup>\*</sup>Adjusted for a two-for-one stock split in February 2012

### MUNCY BANK FINANCIAL, INC. AND SUBSIDIARY

### CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2012 AND 2011

	2012	2011
ASSETS		
Cook and due from honles	\$ 4,213,727	¢ 1926.670
Cash and due from banks Federal funds sold	\$ 4,213,727 3,000,000	\$ 4,836,679 3,000,000
rederat futius soid		3,000,000
Total cash and cash equivalents	7,213,727	7,836,679
Interest-bearing deposits with banks	15,088,990	4,095,385
Available-for-sale securities	41,755,347	43,366,229
Held-to-maturity securities	696	961
Loans, net	243,111,353	228,275,623
Bank premises and equipment, net	5,504,187	5,285,015
Accrued interest receivable	987,404	1,072,017
Other real estate	253,487	81,155
Cash surrender value of life insurance	7,359,285	7,111,105
Other assets	1,700,621	2,878,547
TOTAL ASSETS	\$322,975,097	\$ 300,002,716
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Interest-bearing deposits	\$ 245,771,359	\$ 226,397,044
Noninterest-bearing deposits	29,630,610	29,444,097
Total deposits	275,401,969	255,841,141
Borrowed funds	11,277,600	11,069,001
Accrued interest payable	397,965	386,311
Other liabilities	1,744,250	2,732,534
Total liabilities	288,821,784	270,028,987
SHAREHOLDERS' EQUITY:		
Common stock, par value \$.41 2/3 per share; 3,626,684 shares authorized,		
1,626,684 shares issued	677,785	677,785
Additional paid-in capital	2,801,778	2,563,312
Retained earnings	30,119,753	26,447,746
Accumulated other comprehensive income	1,031,664	1,038,328
Total	34,630,980	30,727,171
Less treasury stock, 83,596 shares in 2012 and 99,896 shares in 2011, at cost	477,667	753,442
		20 072 720
Shareholders' equity, net	34,153,313	29,973,729



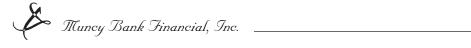
### MUNCY BANK FINANCIAL, INC. AND SUBSIDIARY

### CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

	2012	2011
INTEREST INCOME:		
Interest and fees on loans	\$13,978,973	\$13,654,696
Interest and dividends on investments:	+,,	4, ,,
Taxable	294,217	385,441
Exempt from federal income tax	1,328,916	1,342,768
Interest on deposits with banks	8,144	4,465
Interest on federal funds sold	4,029	5,153
Total interest income	15,614,279	15,392,523
INTEREST EXPENSE:		
Interest on deposits	2,378,576	2,751,024
Interest on other borrowings	83,006	117,815
Interest on short-term borrowings	28,878	44,151
Total interest expense	2,490,460	2,912,990
NET INTEREST INCOME	13,123,819	12,479,533
PROVISION FOR LOAN LOSSES	875,000	825,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	12,248,819	11,654,533
OTHER OPERATING INCOME:		
Service charges on deposit accounts	831,843	837,579
Investment services income	380,087	342,647
Trust department income	141,000	141,000
Other service charges and fees	429,932	119,068
Other operating income	24,535	40,497
Investment securities (losses) gains, net	(585)	
Gain on sale of other real estate		6,802
Total other operating income	1,806,812	1,491,666
OTHER OPERATING EXPENSES:		
Salaries and employee benefits	4,560,470	4,444,626
Occupancy expense, net	411,241	441,978
Furniture and equipment expense	261,601	254,433
Other operating expenses	1,535,277	1,717,604
Data processing expense	349,489	334,392
Pennsylvania shares tax	257,935	236,535
Total other operating expenses	7,376,013	7,429,568
INCOME BEFORE PROVISION FOR INCOME TAXES	6,679,618	5,716,631
PROVISION FOR INCOME TAXES	1,837,936	1,399,402
NET INCOME	4,841,682	4,317,229
OTHER COMPREHENSIVE INCOME,		
Change in net unrealized gain on available-for-sale securities, net of tax	(6,664)	1,128,414
TOTAL COMPREHENSIVE INCOME	\$ 4,835,018	\$ 5,445,643
BASIC EARNINGS PER SHARE	\$ 3.15	\$ 2.84

MUNCY BANK FINANCIAL, INC. AND SUBSIDIARY CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TREASURY STOCK	TOTAL SHAREHOLDERS' EQUITY, NET
Balance, December 31, 2010	\$ 677,785	\$ 2,459,271	\$ 23,148,962	\$ (90,086)	\$ (1,033,832)	\$ 25,162,100
Comprehensive income: Net income Change in net unrealized (loss) gain on available-for-sale securities, net of tax of			4,317,229			4,317,229
\$581,304				1,128,414		1,128,414
Total comprehensive income						5,445,643
Sale of treasury stock (23,446 shares)		104,041			401,290	505,331
Purchase of treasury stock (6,200 shares)					(120,900)	(120,900)
Cash dividends declared, \$0.67 per share			(1,018,445)			(1,018,445)
Balance, December 31, 2011	677,785	2,563,312	26,447,746	1,038,328	(753,442)	29,973,729
Comprehensive income: Net income Change in net unrealized (loss) gain on available-for-sale			4,841,682			4,841,682
securities, net of tax of \$3,433				(6,664)		(6,664)
Total comprehensive income						4,835,018
Sale of treasury stock (16,300 shares)		238,466			275,775	514,241
Cash dividends declared, \$0.76 per share			(1,169,675)			(1,169,675)
Balance, December 31, 2012	\$ 677,785	\$ 2,801,778	\$ 30,119,753	\$ 1,031,664	\$ (477,667)	\$ 34,153,313



### MUNCY BANK FINANCIAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 4,841,682	\$ 4,317,229
Adjustments to reconcile net income to net cash provided by operating activities:	Ų 1,011,00 <u>2</u>	ψ 1,517,22 <i>)</i>
Depreciation Personal	269,462	257,158
Provision for loan losses	875,000	825,000
Amortization and accretion of investment securities	29,028	37,163
Investment securities losses (gains)	585	(4,073)
Gain on sale of other real estate		(6,802)
Deferred taxes	(203,947)	(343,732)
Increase in cash surrender value of life insurance	(248,180)	(2,512,836)
Change in:	( -,,	( ,- ,)
Accrued interest receivable and other assets	1,229,160	(235,069)
Accrued interest payable and other liabilities	(735,870)	554,716
Net cash provided by operating activities	6,056,920	2,888,754
		2,000,734
CASH FLOWS FROM INVESTING ACTIVITIES:		
Available-for-sale securities:		
Proceeds from sales	341,600	438,762
Proceeds from repayment and maturities	10,842,341	13,602,619
Purchases of securities	(9,612,770)	(13,289,984)
Held-to-maturity securities,		
Proceeds from repayment and maturities	265	252
Net increase in loans	(15,964,217)	(14,120,353)
Net (increase) decrease in interest-bearing deposits with banks	(10,993,605)	7,878,920
Acquisition of bank premises and equipment	(488,634)	(91,157)
Proceeds from sale of other real estate	81,155	640,509
Net cash used by investing activities	(25,793,865)	(4,940,432)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in noninterest-bearing demand, savings and other deposit accounts	9,276,588	22,345,682
Net increase (decrease) in certificates of deposit	10,284,240	(9,421,978)
Increase in short-term borrowings	2,010,466	356,434
Proceeds from long-term borrowings		2,650,000
Repayment of long-term borrowings	(1,801,867)	(11,451,752)
Dividends paid	(1,169,675)	(1,018,445)
Proceeds from sale of treasury stock	514,241	505,331
Purchase of treasury stock		(120,900)
Net cash provided by financing activities	19,113,993	3,844,372
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(622,952)	1,792,694
CASH AND CASH EQUIVALENTS, BEGINNING	7,836,679	6,043,985
CASH AND CASH EQUIVALENTS, ENDING	\$ 7,213,727	\$ 7,836,679
CUIDDI EMENITAL CACH ELOW INFORMATIONI.		
SUPPLEMENTAL CASH FLOW INFORMATION:	¢ 2/170 004	\$ 3,075,202
Interest paid	\$ 2,478,806	\$ 3,075,393
Income taxes paid  Total (degrees) in process in proceeding the design (less on excitable for selections).	\$ 1,903,354	\$ 1,895,521 \$ 1,700,718
Total (decrease) increase in unrealized gain/loss on available-for-sale securities	\$ (10,097) \$ 253,487	\$ 1,709,718
Loans transferred to other real estate during the year	\$ 253,487	\$ 376,004

### MUNCY BANK FINANCIAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

#### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Muncy Bank Financial, Inc. (Company) is a Pennsylvania corporation organized as the holding company of The Muncy Bank & Trust Company (Bank). The Bank is a state chartered commercial bank located in Muncy, Pennsylvania, whose principal sources of revenues are derived from its commercial, mortgage, residential real estate, and consumer loan financing as well as providing deposit, investment and trust services to its customers serviced by its five community banking offices.

### **Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. All significant intercompany balances and transactions have been eliminated.

### **Segment Reporting**

Public business enterprises must report financial and descriptive information about their reportable operating segments. The Company has determined that its only reportable segment is community banking.

#### Investment Securities

Held-to-maturity securities include debt securities that the Company has the positive intent and ability to hold to maturity. These securities are reported at amortized cost.

Available-for-sale securities include debt and restricted equity securities not classified as held-to-maturity and expected to be held for an indefinite period of time. Such securities, except for restricted equity securities, are reported at fair value, with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, net of related federal income tax.

Restricted equity securities consist of Federal Home Loan Bank of Pittsburgh (FHLB) and Atlantic Central Bankers' Bank stock and are carried at cost and evaluated for impairment. As a member of FHLB, the Bank is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

The cost of investment debt securities is adjusted for amortization of premiums and accretion of discounts, computed by a method that approximates the effective interest method. Realized gains and losses on sales of investment securities represent the differences between net proceeds and carrying values determined by the specific identification method.

### Loans

Loans are stated at unpaid principal balance, net of unearned income, unamortized deferred loan fees and costs, and an allowance for loan losses. Interest on fixed rate real estate loans and most business loans is accrued on the principal balance using a 360-day year. Interest on other loans is accrued over the term of each loan generally using the simple interest method based on a 365-day year. The Company recognizes



nonrefundable loan origination fees and certain direct loan origination costs over the life of the related loans as an adjustment of loan yield using the interest method.

A loan is considered past due when a required payment is not received by the scheduled due date and is considered delinquent when it is 30 days or more past due. Loans are placed on nonaccrual status when principal or interest is past due 90 days or more and the collection of interest is doubtful except for residential mortgage loans secured by 1-4 family dwellings until it is established that funds are not available for repayment. Interest accrued but not collected as of the date of placement on nonaccrual status is reversed and charged against current income. Interest income on nonaccrual loans is recognized only to the extent of interest payments received. Loans are returned to the accrual status when factors indicating doubtful collectibility cease to exist.

The Company considers a loan to be impaired, based upon current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest according to the contractual terms of the loan agreement. The Company individually evaluates such loans for impairment. Factors considered by management in determining impairment include payment status and collateral value. The measurement of impaired loans is based on the present value of expected future cash flows discounted at the historical effective interest rate, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral. The Company does not accrue interest on certain impaired loans. While a loan is considered impaired, subsequent cash payments received either are applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of the ultimate collectibility of principal and interest. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosure, unless such loans are the subject of a restructuring agreement.

### **Allowance for Loan Losses**

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when a loan is past due 120 days or more with the exception of loans secured by real estate and sufficient equity exists to satisfy the debt. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of their ability to collect loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may effect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

### **Troubled Debt Restructurings**

Loans are classified as a troubled debt restructuring if the Company has granted a concession to a borrower for economic or legal reasons related to a borrower's financial difficulties. Modified terms may include interest rate reductions, extension of payment terms, principal forgiveness, or other actions intended to minimize the Company's loss and to avoid foreclosure or repossession of collateral. In cases where loan terms are modified, the Company measures impairment related to the restructuring and a separate reserve of the allowance for loan losses may be necessary.

### MUNCY BANK FINANCIAL INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

#### **Other Real Estate**

Other real estate acquired through foreclosure or other means is recorded at the lower of its carrying value or fair value of the property at the transfer date, less estimated selling costs. Costs to maintain other real estate are expensed as incurred.

### **Bank Premises and Equipment**

Bank premises and equipment are stated at cost, less accumulated depreciation. Depreciation expense is computed using the straight-line method over the estimated useful lives of the assets. Repair and maintenance expenditures which extend the useful life of an asset are capitalized and other repair expenditures are expensed as incurred. When premises or equipment are retired or sold, the remaining cost and accumulated depreciation are removed from the accounts and any gain or loss is credited or charged to income.

### Leasing

The Company is the lessor of land and buildings under various month-to-month operating leases.

#### **Income Taxes**

The Company and Bank file a consolidated federal income tax return. Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax basis of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

#### Per Share Data

Net income per share of common stock has been computed on the basis of the weighted-average number of shares of common stock outstanding during the period. The number of common shares used in computing basic earnings per share and dividends per share was 1,538,311 in 2012 and 1,518,836 in 2011.

On January 10, 2012, the Board of Directors declared a two-for-one stock split to shareholders of record on February 15, 2012. Per share amounts in the accompanying consolidated financial statements have been adjusted for the split.

#### **Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect reported amounts and disclosures. Actual results could differ from estimated amounts.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral.

The Company's loans are generally secured by specific items of collateral including real property, consumer assets and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination.



Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

### Mortgage Banking Activity

The Company originates certain loans for the express purpose of selling such loans in the secondary market. The Company maintains all servicing rights for these loans. At December 31, 2012 and 2011, the Company serviced loans for the benefit of others totaling \$15,445,754 and \$11,641,726, respectively. Mortgage servicing rights should be recognized as separate assets upon sale of the loans and amortized over the estimated life of the loan serviced. The Company has not recorded the asset and records the fees as revenue when received because the results are not materially different. The Company recognized mortgage servicing fees of approximately \$204,000 and \$116,000 during the years ended December 31, 2012 and 2011, respectively.

#### **Cash Flows**

The Company utilizes the net reporting of cash receipts and cash payments for certain deposit and lending activities. The Company considers cash, amounts due from banks and federal funds sold as cash equivalents, all of which mature within 90 days. Generally, federal funds are purchased and sold for one-day periods.

### **Recent Accounting Standards**

During 2012, the Company adopted Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2011-05, *Comprehensive Income - Presentation of Comprehensive Income*. This ASU revised the presentation requirement for all entities that report items of other comprehensive income. The Company has retrospectively applied the revisions required and has presented other comprehensive income in the consolidated statements of income and comprehensive income.

### **Trust Assets and Income**

Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the consolidated financial statements since such items are not assets of the Company. Trust income is reported on the cash basis, which is not materially different from the accrual basis.

#### **Treasury Stock**

The purchase of the Company's common stock is recorded at cost. At the date of subsequent reissue, the treasury stock account is reduced by the cost of the stock on a specific identification method.

### 2. RESTRICTIONS ON CASH AND DUE FROM BANK ACCOUNTS:

Banks are required to maintain reserves, in the form of cash balances with the Federal Reserve Bank, against their deposit liabilities. The amount of such reserves at December 31, 2012 and 2011 was approximately \$979,000 and \$923,000, respectively.

Deposits with any one financial institution are insured up to \$250,000. The Company maintains cash and cash equivalents with certain financial institutions in excess of federally insured limits.

### 3. COMPREHENSIVE INCOME:

The components of comprehensive income are as follows:

	<u>2012</u>	<u>2011</u>
Unrealized holding (losses) gains on available-for-sale securities arising during the year Reclassification adjustment for realized loss (gain) included in net income	\$(10,682) 585	\$1,713,791 (4,073)
Subtotal	(10,097)	1,709,718
Less tax effect	3,433	581,304
Total	<u>\$ (6,664)</u>	<u>\$1,128,414</u>

### 4. INVESTMENT SECURITIES:

The amortized cost and estimated fair value of investment securities are as follows (in thousands):

December 31, 2012:	Amortized <u>Cost</u>	Gross Unrealized <u>Gains</u>	Gross Unrealized <u>Losses</u>	Estimated Fair <u>Value</u>
Held-to-Maturity Securities, Residential mortgage-backed securities	<u>\$ 1</u>	<u>\$</u>	<u>\$</u>	<u>\$ 1</u>
Available-for-Sale Securities: Obligations of U.S. government corporations and agencies Obligations of state and political subdivisions Residential mortgage-backed securities Corporate securities	\$ 2,000 31,018 6,026 250	\$ 12 1,144 421 1	\$ 14	\$ 2,012 32,148 6,447 
Total debt securities	39,294	1,578	14	40,858
Restricted equity securities	897			897
Total available-for-sale securities	<u>\$40,191</u>	<u>\$ 1,578</u>	<u>\$ 14</u>	<u>\$41,755</u>
December 31, 2011: Held-to-Maturity Securities, Residential mortgage-backed securities	<u>\$ 1</u>	<u>\$</u>	<u>\$</u>	<u>\$ 1</u>
Available-for-Sale Securities: Obligations of U.S. government corporations and agencies Obligations of state and political subdivisions Residential mortgage-backed securities Corporate securities	\$ 3,250 28,745 8,059 500	\$ 7 1,201 377 1	\$ 1 12	\$ 3,257 29,945 8,436 489
Total debt securities	40,554	1,586	13	42,127
Restricted equity securities				1,239
Total available-for-sale securities	<u>\$41,793</u>	<u>\$1,586</u>	<u>\$ 13</u>	<u>\$43,366</u>

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

	Amortized Cost	Estimated Fair <u>Value</u>
Held-to-Maturity Securities, Residential mortgage-backed securities	<u>\$ 1</u>	<u>\$ 1</u>
Available-for-Sale Securities:		
Due within 1 year	\$ 695	\$ 695
Due after 1 year through 5 years	1,561	1,600
Due after 5 years through 10 years	20,638	21,436
Due after 10 years	10,374	10,680
Total	33,268	34,411
Residential mortgage-backed securities	6,026	6,447
Total debt securities	<u>\$39,294</u>	<u>\$40,858</u>

Investment securities with a carrying value of approximately \$37,600,000 and \$29,673,000 at December 31, 2012 and 2011, respectively, were pledged to secure public and trust funds, certain other deposits and for other purposes as provided by law.

Gross realized gains and gross realized losses on investment securities transactions are summarized below for the years ended December 31, 2012 and 2011. These gains and losses were recognized using the specific identification method.

	<u>2012</u>	2011
Available-for-sale securities: Gross gains Gross losses	<u>\$(585)</u>	\$ 8,011 _(3,938)
Net gains (losses)	<u>\$(585</u> )	\$ 4,073

Gross unrealized losses and fair values are shown in the following table, aggregated by investment category and length of time individual securities have been in a continuous unrealized loss position, at December 31, 2012 and 2011 (in thousands).

	Less than	12 Months	12 Months	or Greater	To	otal
	Estimated	Gross	Estimated	Gross	Estimated	Gross
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	<u>Value</u>	Losses	<u>Value</u>	Losses	<u>Value</u>	Losses
December 31, 2012: Obligations of state and political subdivisions	<u>\$1,582</u>	<u>\$14</u>	<u>\$</u>	<u>\$</u>	<u>\$1,582</u>	<u>\$14</u>
December 31, 2011: Obligations of state and political subdivisions Corporate securities			\$250 	\$ 1 	\$ 250 238	\$ 1 _12
Total	<u>\$</u>	<u>\$</u>	<u>\$488</u>	<u>\$13</u>	<u>\$ 488</u>	<u>\$13</u>

At December 31, 2012 and 2011, the number of unrealized loss positions in investment securities totaled 6 and 2, respectively. Certain securities are guaranteed by either the U.S. government or other governments. These unrealized losses relate principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As management has the ability to hold debt securities until maturity or for the foreseeable future, no declines are deemed to be other-than-temporary.

### 5. LOANS AND ALLOWANCE FOR LOAN LOSSES:

Major segments of the loan portfolio are summarized as follows (in thousands) as of December 31, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Personal	\$ 9,916	\$ 10,159
Credit lines	24,622	28,809
Business	41,722	31,192
Real Estate	<u>170,776</u>	161,585
Gross loans	247,036	231,745
Less allowance for loan losses	<u>3,925</u>	3,469
Loans, net	<u>\$243,111</u>	<u>\$228,276</u>

At December 31, 2012 and 2011, net unamortized loan fees and costs of \$337,950 and \$337,542, respectively, have been offset against the carrying value of loans shown above.

The Company has no commitments to loan additional funds to borrowers whose loans have been modified.

The Company grants commercial, industrial, residential and personal loans to customers primarily in Lycoming and Northumberland counties, Pennsylvania. Although the Company has a diversified loan portfolio, a significant portion of its debtor's ability to honor their contracts is dependent on, among other things, the economic conditions within this region.

#### Allowance for Loan Losses

The following tables roll forward the balance of the allowance for loan losses by portfolio segment segregated into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of December 31, 2012 and 2011. Activity in the allowances is presented for the years ended December 31, 2012 and 2011.

	Personal	Credit <u>Lines</u>	Business	Real <u>Estate</u>	<u>Total</u>
2012: Beginning balance Charge offs Recoveries Provision Ending balance	\$ 59 (68) \(\frac{127}{\\$118}\)	\$358 (90) 3 23 \$294	\$ 843 (274) <u>204</u> <u>\$ 773</u>	$$2,209$ $ \begin{array}{r} 10 \\ \underline{521} \\ \underline{$2,740} \end{array} $	\$3,469 (432) 13 <u>875</u> <u>\$3,925</u>
Individually evaluated for impairment	<u>\$</u>	<u>\$ 5</u>	<u>\$ 68</u>	<u>\$ 567</u>	<u>\$ 640</u>
Collectively evaluated for impairment	<u>\$118</u>	<u>\$289</u>	<u>\$ 705</u>	<u>\$2,173</u>	<u>\$3,285</u>
2011: Beginning balance Charge offs Recoveries Provision Ending balance	\$ 81 (98) 1 <u>75</u> \$ 59	\$347 (31) $\frac{42}{$358}$	\$ 340 (30) $\frac{533}{$843}$	\$2,069 (55) 20 <u>175</u> \$2,209	\$2,837 (214) 21 <u>825</u> <u>\$3,469</u>
Individually evaluated for impairment	<u>\$ 15</u>	<u>\$ 12</u>	<u>\$ 478</u>	<u>\$ 99</u>	<u>\$ 604</u>
Collectively evaluated for impairment	<u>\$ 44</u>	<u>\$346</u>	<u>\$ 365</u>	<u>\$2,110</u>	<u>\$2,865</u>

An allowance for loan losses (ALL) is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of capital, past and anticipated loss experience, and the amount of non-performing loans. Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the ALL.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. For general allowances, historical loss trends are calculated over a three-year period and are used in estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors which include national and local economic trends and conditions; levels of and trends in delinquency rates and nonaccrual loans; trends in volume and terms of loans; effect of changes in lending policies, experience, ability and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint. During 2012, the qualitative factors for economic trends was increased for business loans, trends in terms and volume were increased for all loan types, and past due loan volumes were increased for personal, business and real estate loans.

### **Impaired Loans**

The following table summarizes the primary segments of the loan portfolio segregated into loans individually evaluated for impairment and loans collectively evaluated for impairment as of December 31, 2012 and 2011 (in thousands):

December 31, 2012:	Personal	Credit <u>Lines</u>	Business	Real Estate	<u>Total</u>
Total loans	<u>\$ 9,916</u>	<u>\$24,622</u>	<u>\$41,722</u>	<u>\$170,776</u>	<u>\$247,036</u>
Individually evaluated for impairment	<u>\$ 5</u>	<u>\$ 198</u>	<u>\$ 906</u>	\$ 3,619	<u>\$ 4,728</u>
Collectively evaluated for impairment	\$ 9,911	<u>\$24,424</u>	<u>\$40,816</u>	<u>\$167,157</u>	<u>\$242,308</u>
December 31, 2011:					
Total loans	<u>\$ 10,159</u>	<u>\$28,809</u>	<u>\$31,192</u>	<u>\$161,585</u>	<u>\$231,745</u>
Individually evaluated for impairment	<u>\$ 39</u>	<u>\$ 40</u>	\$ 1,313	<u>\$ 879</u>	\$ 2,271
Collectively evaluated for impairment	<u>\$ 10,120</u>	<u>\$28,769</u>	<u>\$29,879</u>	<u>\$160,706</u>	<u>\$229,474</u>

The following table summarizes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable, at December 31, 2012 and 2011 (in thousands):

December 31, 2012:	Recorded <u>Investment</u>	Unpaid Principal	Related Allowance	Average Recorded <u>Investment</u>	Interest Income Recognized
With no related allowance recorded: Personal Credit lines Business Real Estate					
Total	<u>\$</u>	<u>\$</u>	<u>\$</u>	\$	<u>\$</u>

	Recorded Investment	Unpaid <u>Principal</u>	Related <u>Allowance</u>	Average Recorded <u>Investment</u>	Interest Income Recognized
With an allowance recorded: Personal Credit lines Business Real Estate	\$ 5 198 906 3,619	\$ 5 198 906 3,619	\$ 5 68 567	\$ 6 199 890 _3,650	\$ 5 44 63
Total	<u>\$4,728</u>	<u>\$4,728</u>	<u>\$ 640</u>	<u>\$4,745</u>	<u>\$112</u>
Total: Personal Credit lines Business Real Estate	\$ 5 198 906 3,619	\$ 5 198 906 3,619	\$ 5 68 567	\$ 6 199 890 3,650	\$ 5 44 <u>63</u>
Total	<u>\$4,728</u>	<u>\$4,728</u>	<u>\$640</u>	<u>\$4,745</u>	<u>\$112</u>
December 31, 2011:  With no related allowance recorded: Personal Credit lines Business Real Estate					
Total	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>
With an allowance recorded: Personal Credit lines Business Real Estate	\$ 39 40 1,313 	\$ 39 40 1,313 879	\$ 15 12 478 	\$ 50 43 1,325 <u>886</u>	\$ 2 2 75 <u>28</u>
Total	<u>\$2,271</u>	<u>\$2,271</u>	<u>\$604</u>	<u>\$2,304</u>	<u>\$107</u>
Total: Personal Credit lines Business Real Estate	\$ 39 40 1,313 	\$ 39 40 1,313 <u>879</u>	\$ 15 12 478 99	\$ 50 43 1,325 886	\$ 2 2 75 <u>28</u>
Total	<u>\$2,271</u>	<u>\$2,271</u>	<u>\$604</u>	<u>\$2,304</u>	<u>\$107</u>

### **Credit Quality**

The Company has developed credit quality indicators which are assigned to individual loans to measure and report credit risk exposure as follows:

Strong - minimum loss exposure; probability of serious rapid financial deterioration extremely small; excellent earnings record; and overall upward trends.

Satisfactory - credits of reasonably acceptable risk based on average credit strength and/or repayment sources. Unfavorable factors may be present, but financial trends are generally positive. The margin of protection is susceptible to more rapid deterioration. Any negatives are adequately compensated for by the loan structure, administrative controls or collateral.

Watch - slightly below average quality. Financial condition has both positive and negative aspects with some adverse tendencies noted. Probability of deterioration if adverse factors prevail.

Special Mention - a special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the bank's credit position at some future date.



Substandard - substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any.

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

Loss - loans classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Company has a loan rating process with layers of internal and external oversight. Generally, personal, credit lines and real estate loans are included in the strong category unless a specific action, such as bankruptcy, repossession, death or significant delay in payment occurs to raise awareness of a possible credit event. The Company's loan officers are responsible for timely and accurate risk rating of the loans in each of their portfolios at origination and on an ongoing basis under management supervision. All business loans are reviewed annually to ensure appropriateness of the credit quality. In addition, the Company engages an external consultant to perform an annual loan review. Generally, the external consultant reviews the 100 largest borrowing credits, a sample of those from 101 to 125, delinquencies (30 days and over) and insider credits.

Loan portfolio segments are classified by credit quality indicators as of December 31, 2012 and 2011 (in thousands):

	Personal	Credit Lines	Business	Real Estate	<u>Total</u>
December 31, 2012: Strong Satisfactory	\$ 9,897	\$24,622	\$34,031	\$168,256	\$236,806
Watch Special mention	9		4,032 1,567	931	4,972 1,567
Substandard Doubtful	10		2,092	1,589	3,691
Loss					
Total	<u>\$ 9,916</u>	\$24,622	<u>\$41,722</u>	<u>\$170,776</u>	<u>\$247,036</u>
December 31, 2011:					
Strong Satisfactory	\$10,025	\$28,809	\$28,613	\$158,882	\$226,329
Watch	25		510	783	1,318
Special mention	60		1,077	284	1,421
Substandard	49		992	1,636	2,677
Doubtful					
Loss					
Total	\$10,159	<u>\$28,809</u>	\$31,192	<u>\$161,585</u>	<u>\$231,745</u>

### Age Analysis of Past Due Loans

Management monitors the performance and credit quality of the loan portfolio by analyzing the length of time a recorded payment is past due. The following table presents the loan portfolio segments summarized by aging categories as of December 31, 2012 and 2011 (in thousands):

December 31, 2012:	<u>Current</u>	30-59 Days Past <u>Due</u>	60-89 Days Past <u>Due</u>	90 Days + Past <u>Due</u>	Total Past <u>Due</u>	Total <u>Loans</u>	Recorded Investment > 90 Days and <u>Accruing</u>
Personal Credit lines Business	\$ 9,891 24,499 41,722	\$ 20 33		\$ 5 90	\$ 25 123	\$ 9,916 24,622 41,722	
Real Estate	164,007	4,240	<u>\$91</u>	2,438	6,769	170,776	
Total	<u>\$240,119</u>	<u>\$4,293</u>	<u>\$91</u>	<u>\$2,533</u>	<u>\$6,917</u>	<u>\$247,036</u>	\$
December 31, 2011:							
Personal Credit lines Business Real Estate	\$ 10,097 28,652 31,192	\$ 19 1	\$60	\$ 43 96	\$ 62 157	\$ 10,159 28,809 31,192	
Total	159,923 \$229,864	<u>29</u> <u>\$ 49</u>	<u>\$60</u>	1,633 \$1,772	1,662 \$1,881	161,585 \$231,745	<u>\$</u>

### **Nonaccrual Loans**

The following table presents loans by segment on nonaccrual status as of December 31, 2012 and 2011 (in thousands):

	<u>2012</u>	<u>2011</u>
Personal Credit Lines	\$ 5 90	\$ 43 161
Business Real Estate	2,441	1,916
Total	<u>\$2,536</u>	<u>\$2,120</u>

### 6. BANK PREMISES AND EQUIPMENT:

Bank premises and equipment are summarized as follows (in thousands):

	December 31,	
	<u>2012</u>	<u>2011</u>
Land	\$1,627	\$1,627
Bank premises	4,737	4,736
Equipment, furniture and fixtures	1,060	971
Construction in progress	<u>361</u>	
Total	7,785	7,334
Less accumulated depreciation	2,281	2,049
Less accumulated depreciation	2,201	2,049
Bank premises and equipment, net	\$5,504	\$5,285
24 p	<u> </u>	90,200



Depreciation of bank premises and equipment charged against earnings amounted to \$269,462 and \$257,158 for the years ended December 31, 2012 and 2011, respectively.

#### 7. DEPOSITS:

At December 31, 2012, the scheduled maturities of certificates of deposits are as follows (in thousands):

2013 2014	\$ 87,214 31,377
2015	7,270
2016	5,881
2017	<u>12,696</u>
Total	\$144,438

Certificates of deposit of \$100,000 or more totaled approximately \$64,185,000 and \$57,203,000 at December 31, 2012 and 2011, respectively. Interest expense related to these deposits was approximately \$879,000 and \$992,000 for the years ended December 31, 2012 and 2011, respectively.

### 8. BORROWED FUNDS:

Borrowed funds include the following for the years ended December 31(in thousands):

Securities sold under agreements to repurchase (a) Other borrowed funds (b) Federal Home Loan Bank of Pittsburgh (FHLB) advances (c)	\$\frac{2012}{7,434}\$ 3,844	\$ 5,423 5,646
Federal funds purchased (d)		
Total borrowed funds	\$11.278	\$11.069

- (a) Securities sold under agreements to repurchase mature within 1 to 30 days. The interest rates on these agreements ranged from .25% to .75% and .00001% to 2.25% at December 31, 2012 and 2011, respectively. The fair values of the underlying securities at December 31, 2012 and 2011 were \$7,783,322 and \$5,721,305, respectively.
- (b) Other borrowed funds consist of separate loans with the FHLB. These loans bear interest at rates which range from 1.10% to 6.42% per annum and mature at various dates through year 2026.
- (c) The Bank has available two types of borrowings with the FHLB. Advances under the FHLB "Open RepoPlus" are short-term borrowings maturing within one year and bear interest at a variable rate based on a requested interest payment frequency. Advances under the FHLB "RepoPlus" and "Mid-Term Repo" are borrowings maturing from 1 day to 3 years and bear interest either at a fixed rate or an adjustable rate set at the time of funding. The Company has a borrowing limit under these arrangements of approximately \$121,921,000 exclusive of any outstanding advances. All advances are collateralized by the Company's FHLB stock, mortgage-backed securities and first mortgage loans under a blanket floating-lien agreement.
- (d) The Bank has an unsecured federal funds credit line which totals \$5,000,000 with a correspondent bank.

The following table summarizes the maturities of other borrowed funds at December 31, 2012 (in thousands):

2013 2014 2015	\$1,602 1,602 602
2016 2017 Thereafter	3 3 3 <u>32</u>
Total	<u>\$3,844</u>

### 9. INCOME TAXES:

The provision for income taxes is comprised of the following (in thousands):

	Years E	Years Ended		
	Decembe	er 31,		
	<u>2012</u>	2011		
Currently payable	\$2,042	\$1,743		
Deferred benefit	<u>(204</u> )	(344)		
Provision for income taxes	<u>\$1,838</u>	\$1,399		

The tax effects of deductible and taxable temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows (in thousands):

	Decer	nber 31,
Deferred tax assets:	2012	<u>2011</u>
Allowance for loan losses	\$1,261	\$1,106
Supplemental retirement	454	362
Accrued interest receivable on nonaccrual loans	<u>82</u>	95
Total	1,797	1,563
Deferred tax liabilities:		
Premises and equipment	221	227
Unrealized holding gain on available-for-sale securities	532	535
Other	38	2
Total	<u>791</u>	<u>764</u>
Deferred tax asset, net	<u>\$1,006</u>	<u>\$ 799</u>

A reconciliation between the expected statutory income tax rate and the effective income tax rate on income before income tax follows (in thousands):

	Years Ended December 31,				
	201	<u>2</u>	<u>2011</u>		
	<u>Amount</u>	<u>%</u>	Amount	<u>%</u>	
Provision at statutory rate	\$2,271	34.0	\$1,944	34.0	
Tax-exempt income	(425)	(6.4)	(425)	(7.4)	
Nondeductible interest expense	16	.3	19	.3	
Other, net	(24)	(.4)	(139)	(2.4)	
Effective income tax and rate	<u>\$1,838</u>	27.5	<u>\$1,399</u>	24.5	

The Company's policy is to recognize interest related to income taxes in interest expense and interest income, and recognize penalties in operating expenses. During 2012 and 2011, the Company was not required to recognize interest or penalties related to income taxes.

The Company, as of December 31, 2012, had taken no tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months.

Tax years 2009, 2010 and 2011 remain subject to examination by major tax jurisdictions.

### 10. EMPLOYEE BENEFIT PLANS:

The Company maintains two defined contribution plans covering substantially all of its employees. The Company has accrued the cost of its defined contribution plans for the years ended December 31, 2012 and 2011. The Company's 401(k) defined contribution plan holds 200,083 and 181,622 shares of the Company's stock at December 31, 2012 and 2011, respectively. Employee benefit plan expense for the years ended December 31, 2012 and 2011, amounted to approximately \$407,000 and \$348,000, respectively.

The Company has split-dollar life insurance policies on the lives of key executive officers at December 31, 2012 and 2011, respectively. The Company owns the cash surrender value while the death benefit proceeds in excess of the cash surrender value is endorsed to the key executive or beneficiary. The policies were paid with a single premium and have a combined death benefit of approximately \$4,898,000 and \$4,858,000 at December 31, 2012 and 2011, respectively. The cash surrender value of these policies was \$2,226,451 and \$2,147,349 at December 31, 2012 and 2011, respectively.

The Company sponsors two non-qualified, non-funded supplemental retirement plans, one for its executives and one for its directors, for which the Company has purchased cost recovery life insurance on the lives of the participants. The participant is the insured person under the policy and the Company is the owner and beneficiary. The amount of the coverage is designed to provide sufficient revenues to cover all costs of the plans if assumptions made as to mortality experience, policy earnings and other factors are realized. At December 31, 2012 and 2011, the cash surrender value of these policies was \$5,132,834 and \$4,963,756, respectively.

### 11. RELATED PARTY TRANSACTIONS:

In the normal course of business, loans are extended to directors, executive officers and their associates. In management's opinion, all of these loans are on substantially the same terms and conditions as loans to other individuals and businesses of comparable creditworthiness. A summary of loan activity for those directors, executive officers, and their associates is as follows (in thousands):

	Beginning <u>Balance</u>	Additions	Amounts Collected	Ending Balance
2012	\$5,561	\$1,649	\$3,052	\$4,158
2011	\$5.635	\$1.109	\$1.183	\$5.561

The Company held related party deposits of approximately \$981,000 and \$803,000 at December 31, 2012 and 2011, respectively.

### 12. OFF-BALANCE SHEET RISK:

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit, interest rate or liquidity risk in excess of the amount recognized in the balance sheets. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit, standby letters of credit and financial guarantees written is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support financial instruments with off-balance sheet credit risk.

Financial instruments whose contract amounts represent credit risk (in thousands):

	Decem	ber 31,
	<u>2012</u>	<u>2011</u>
Commitments to grant loans	<u>\$ 666</u>	\$ 1,830
Unfunded commitments under lines of credit	<u>\$24,904</u>	<u>\$24,223</u>
Standby letters of credit	<u>\$ 954</u>	<u>\$ 516</u>

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Company on extension of credit is based on management's credit assessment of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment and income-producing commercial properties.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Company is committed.

Standby letters of credit are conditional commitments issued by the Company guaranteeing performance by a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

The Company has not been required to perform on any financial guarantees during the past two years. The Company has not incurred any losses on its commitments in either 2012 or 2011.

### 13. COMMITMENTS AND CONTINGENCIES:

The Company and Bank are subject to claims and lawsuits which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the consolidated financial statements of the Company.

### 14. REGULATORY MATTERS:

Capital - The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by its primary federal regulator, the Federal Deposit Insurance Corporation (FDIC) and the Commonwealth of Pennsylvania Department of Banking. Failure to meet the minimum regulatory capital requirements can initiate certain mandatory, and possible additional discretionary actions by regulators, and if undertaken, could have a direct material affect on the Company's financial statements. Under the regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines involving quantitative measures of the Company's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classification under the prompt corrective action guidelines are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios of total risk-based capital and Tier I capital to risk-weighted assets (as defined in the regulations), and Tier I capital to average total assets (as defined). Management believes, as of December 31, 2012 and 2011, that the Company meets all capital adequacy requirements to which it is subject.



As of June 30, 2012, the most recent notification from the FDIC, the Company was categorized as well capitalized under the regulatory framework for prompt corrective action. To remain categorized as well capitalized, the Company will have to maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as disclosed in the table below. There are no conditions or events since the most recent notification that management believes have changed the Company's prompt corrective action category.

The following table reflects the Company's and Bank's actual regulatory capital and ratios as well as the ratios required for the Company and Bank to be considered adequately capitalized under the regulatory framework for prompt corrective action (in thousands).

			For Ca	ıpital		
			Adequ	ласу	То Ве	Well
	Actual		Purpo	oses	Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2012:	'					
Total Risk-Based Capital						
(to Risk-Weighted Assets)						
Company	\$36,138	15.1%	\$19,180	8.0%	\$23,975	10.0%
Bank	33,980	14.2	19,180	8.0	23,975	10.0
Tier I Capital (to Risk-Weighted						
Assets)						
Company	33,121	13.8	9,590	4.0	14,385	6.0
Bank	30,963	12.9	9,590	4.0	14,385	6.0
Tier I Capital (to Average Total						
Assets)						
Company	33,121	10.4	12,797	4.0	15,996	5.0
Bank	30,963	9.7	12,797	4.0	15,996	5.0
December 31, 2011:						
Total Risk-Based Capital						
(to Risk-Weighted Assets)						
Company	\$31,272	13.6%	\$18,358	8.0%	\$22,948	10.0%
Bank	30,167	13.2	18,358	8.0	22,948	10.0
Tier I Capital (to Risk-Weighted						
Assets)						
Company	28,396	12.4	9,179	4.0	13,769	6.0
Bank	27,291	11.9	9,179	4.0	13,769	6.0
Tier I Capital (to Average Total						
Assets)						
Company	28,396	9.5	11,928	4.0	14,910	5.0
Bank	27,291	9.2	11,928	4.0	14,910	5.0

Dividends - Banking regulations limit the amount of dividends that may be paid to the Company by the Bank without prior approval of the Bank's regulatory agency. Retained earnings against which dividends may be paid without prior approval of the banking regulators amounted to approximately \$28,124,000 at December 31, 2012, subject to the minimum capital ratio requirements noted above.

Loans - Restrictions imposed by federal law prohibit the Company from borrowing from the Bank unless the loans are secured in specific amounts. Such secured loans to the Company are generally limited to 15% of the Bank's shareholders' equity (excluding unrealized gains on available-for-sale securities) or \$4,056,000 at December 31, 2012.

Other - This statement has not been reviewed or confirmed for accuracy or relevance by the FDIC.

#### 15. FAIR VALUE MEASUREMENTS:

FASB ASC 820, Fair Value Measurements and Disclosures, provides the framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level I measurements) and the lowest priority to unobservable inputs (Level III measurements). The three levels of the fair value hierarchy under FASB ASC 820 are described as follows:

Level I: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level II: Inputs to the valuation methodology include:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in inactive markets;
- Inputs other than quoted prices that are observable for the asset or liability;
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level II input must be observed for substantially the full term of the asset or liability.

Level III: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs. Transfers of financial instruments between levels within the fair value hierarchy are recognized on the date management determines that the underlying circumstances or assumptions have changed.

The Company believes that its valuation techniques are appropriate and consistent with the techniques used by other market participants. However, the use of different methodologies and assumptions could result in a different estimate of fair values at the reporting date.

### Financial Assets Measured at Fair Value on a Recurring Basis

Investment securities measured at fair value on a recurring basis and the valuation method used at December 31, 2012 and 2011 are as follows (in thousands):

	Level I	Level II	Level III	<u>Total</u>
December 31, 2012:				
Available-for-sale securities:				
Obligations of U.S. government corporations				
and agencies		\$ 2,012		\$ 2,012
Obligations of state and political subdivisions		32,148		32,148
Residential mortgage-backed securities		6,447		6,447
Corporate securities	-	<u>251</u>		<u>251</u>
Total	\$	\$40,858	\$	\$40,858

	<u>Level I</u>	Level II	Level III	<u>Total</u>
December 31, 2011:				
Available-for-sale securities:				
Obligations of U.S. government corporations				
and agencies		\$ 3,257		\$ 3,257
Obligations of state and political subdivisions		29,945		29,945
Residential mortgage-backed securities		8,436		8,436
Corporate securities		489		489
Total	<u>\$</u>	<u>\$42,127</u>	<u>\$</u>	<u>\$42,127</u>

The Company held no investment securities classified as Level I. The estimated fair values of all debt securities classified as Level II are obtained from nationally-recognized third-party pricing agencies. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Company (observable inputs), and are therefore classified as Level II within the fair value hierarchy. The Company does not have any Level III inputs for investment securities. There were no transfers between valuation levels during 2012 and 2011.

### Financial and Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

Impaired loans (financial) and other real estate (nonfinancial) measured at fair value on a nonrecurring basis and the valuation methods used at December 31, 2012 and 2011 are as follows (in thousands):

	Level I	Level II	Level III	<u>Total</u>
December 31, 2012:				
Impaired loans:				
Personal			\$ 5	\$ 5
Credit lines			193	193
Business			838	838
Real estate			3,052	3,052
Total impaired loans			4,088	4,088
Other real estate			<u>253</u>	<u>253</u>
Total	<u>\$</u>	\$	<u>\$4,341</u>	<u>\$4,341</u>
December 31, 2011:				
Impaired loans:				
Personal			\$ 24	\$ 24
Credit lines			28	28
Business			835	835
Real estate			780	780
Total impaired loans			1,667	1,667
Other real estate			<u>81</u>	81
Total	\$	\$	<u>\$1,748</u>	\$1,748

The fair value of loans considered impaired is generally based on the fair value of the loan's collateral. A collateral evaluation is performed periodically (typically quarterly) which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values. Other real estate is valued based on the lower of carrying value or fair value provided by independent third-party appraisals of the properties, less estimated selling costs. These assets are included as Level III fair values, based upon the lowest level that is significant to the fair value measurements. There were no transfers between valuation levels in 2012 and 2011.

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

	Quantitative Information about Level III Fair Value Measurements				
	Fair Value Estimate	ValuationTechnique	<u>Unobservable Input</u>	Range	
Assets at December 31, 2012: Impaired Loans	\$4,088	Third-party appraisal of collateral	Appraisal adjustments	0-25%	
Other Real Estate	253	Third-party appraisal of collateral, less estimated selling costs	Appraisal adjustments	0-25%	

The following table presents fair value information about financial instruments, whether or not recognized in the consolidated balance sheets, for which it is practicable to estimate that value. The actual carrying amounts and estimated fair values of the Company's financial instruments that are included in the consolidated balance sheets are as follows (in thousands):

	Carrying				
December 31, 2012:	<u>Amount</u>	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
FINANCIAL ASSETS:					
Cash and due from banks and					
interest-bearing deposits					
with banks	\$ 19,303	\$ 19,303			\$ 19,303
Federal funds sold	3,000	3,000	A		3,000
Investment securities	41,755		\$41,755		41,755
Loans, net	243,111	007		\$253,081	253,081
Accrued interest receivable	987	987			987
Cash surrender value of bank	<b>5.25</b> 0	<b>5.25</b> 0			7.250
owned life insurance	7,359	7,359			7,359
FINANCIAL LIABILITIES:					
Deposits	275,402			273,142	273,142
Borrowed funds	11,278	11,278		,	11,278
Accrued interest payable	398	398			398
OFF-BALANCE SHEET					
FINANCIAL INSTRUMENTS:					
Lending commitments and					
	\$	\$	\$	\$	\$
Lending commitments and	·	\$	\$	\$	\$
Lending commitments and letters of credit	Carrying	·		·	·
Lending commitments and letters of credit  December 31, 2011:	·	\$ <u>Level I</u>	\$ <u>Level II</u>	\$ <u>Level III</u>	\$ <u>Total</u>
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS:	Carrying	·		·	·
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and	Carrying	·		·	·
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and interest-bearing deposits	Carrying Amount	<u>Level I</u>		·	<u>Total</u>
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and	Carrying Amount \$ 8,932	<u>Level I</u> \$ 8,932		·	<u>Total</u> \$ 8,932
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and interest-bearing deposits with banks	Carrying Amount	<u>Level I</u>		·	<u>Total</u>
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and interest-bearing deposits with banks Federal funds sold	Carrying <u>Amount</u> \$ 8,932 3,000 43,367	<u>Level I</u> \$ 8,932	<u>Level II</u>	·	Total \$ 8,932 3,000
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and interest-bearing deposits with banks Federal funds sold Investment securities	Carrying Amount  \$ 8,932 3,000	<u>Level I</u> \$ 8,932	<u>Level II</u>	Level III	Total \$ 8,932 3,000 43,367
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and interest-bearing deposits with banks Federal funds sold Investment securities Loans, net	Carrying Amount  \$ 8,932 3,000 43,367 228,276	Level I \$ 8,932 3,000	<u>Level II</u>	Level III	Total \$ 8,932 3,000 43,367 239,457
Lending commitments and letters of credit  December 31, 2011: FINANCIAL ASSETS: Cash and due from banks and interest-bearing deposits with banks Federal funds sold Investment securities Loans, net Accrued interest receivable	Carrying Amount  \$ 8,932 3,000 43,367 228,276	Level I \$ 8,932 3,000	<u>Level II</u>	Level III	Total \$ 8,932 3,000 43,367 239,457



	Carrying Amount	Level I	Level II	Level III	Total
FINANCIAL LIABILITIES:	1 11110 01110	<u> </u>	<u> </u>	<u> </u>	10001
Deposits	\$255,841			\$253,645	\$253,645
Borrowed funds	11,069	\$ 11,069			11,069
Accrued interest payable	386	386			386
OFF BALANCE SHEET FINANCIAL INSTRUMENTS: Lending commitments and					
letters of credit	\$	\$	\$	\$	\$

Certain of the Company's financial instruments are not measured at fair value in the consolidated financial statements. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from disclosure requirements. Therefore, the aggregate fair value amounts presented may not represent the underlying fair value on the Company.

The following methods and assumptions were used by the Company in estimating the fair value for financial instruments:

### Cash and Due From Banks, Interest-Bearing Deposits with Banks and Federal Funds Sold (Carried at Cost)

The carrying amounts reported in the balance sheets approximate fair value due to the short-term nature of these assets and they do not present unanticipated credit concerns.

#### **Investment Securities**

The fair values of held-to-maturity securities and investment securities available-for-sale are based on quoted market prices as of the balance sheet dates, where available. In cases where a market price is not available, external pricing services that approximate fair value are used. For certain instruments, fair value is estimated by obtaining quotes from independent securities dealers. The carrying value of restricted equity securities approximates fair value based on the redemption provisions of the stock.

### Loans (Carried at Cost)

Fair values are estimated for portfolios of loans with similar financial characteristics. For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans (for example, fixed rate commercial real estate, rental property mortgage loans and commercial and industrial loans) are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics.

### Accrued Interest Receivable and Payable (Carried at Cost)

The carrying value of accrued interest receivable and payable approximates fair value because they are generally received or paid in 90 days or less and do not present unanticipated credit concerns.

### Cash Surrender Value of Life Insurance

The carrying value of cash surrender value of life insurance approximates fair value based on applicable redemption provisions.

### **Deposits (Carried at Cost)**

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings and NOW accounts, and money market and checking accounts, is the amount payable on demand as of December 31, 2012 and 2011. For time deposits, fair value is estimated by discounting the contractual cash flows using a discount rate equal to the rate currently offered for similar deposits of similar maturities.

### **Borrowed Funds (Carried at Cost)**

Rates available to the Company for borrowed funds with similar terms and remaining maturities are used to estimate the fair value of borrowed funds.

### Commitments to Extend Credit and Standby Letters of Credit (Disclosed at Cost)

There is no material difference between the notional amount and the estimated fair value of off-balance sheet items which are primarily comprised of unfunded loan commitments which are generally priced at market at the time of funding.

### 16. CONDENSED FINANCIAL STATEMENTS OF PARENT COMPANY:

Following are condensed financial statements for Muncy Bank Financial, Inc. (in thousands):

	Decembe	er 31,
BALANCE SHEETS	<u>2012</u>	<u>2011</u>
ASSETS:		
Cash	\$ 2,158	\$ 1,644
Investment in subsidiary	31,995	28,330
Total assets	<u>\$34,153</u>	\$29,974
CHAREHOLDERO FOLLEN		
SHAREHOLDERS' EQUITY:	\$ 678	\$ 678
Common stock Additional paid-in capital	\$ 678 2,802	\$ 678 2,563
Retained earnings	30,120	26,448
Accumulated other comprehensive gain	1,031	1,038
Treasury stock	(478)	(753)
reastly stock	(470)	
Total shareholders' equity	<u>\$34,153</u>	<u>\$29,974</u>
	Years Ended D	ecember 31,
STATEMENTS OF INCOME	<u>2012</u>	2011
INCOME:	e 1 170	6 1 010
Dividends from subsidiary	\$ 1,170	\$ 1,019
Equity in undistributed earnings	3,672	3,299
Net income	<u>\$ 4,842</u>	<u>\$ 4,318</u>
STATEMENTS OF CASH FLOWS		
OPERATING ACTIVITIES:		
Net income	\$ 4,842	\$ 4,318
Adjustments to reconcile net income to net cash		
provided by operating activities,		
Undistributed earnings of subsidiary	(3,672)	(3,299)
Net cash provided by operating activities	1,170	1,019
Not eash provided by operating activities	1,170	
FINANCING ACTIVITIES:		
Cash dividends paid	\$(1,170)	\$(1,018)
Proceeds from sale of treasury stock	514	505
Purchase of treasury stock		(121)
Net cash used by financing activities	<u>(656</u> )	(634)
INCREASE IN CASH	514	385
CASH, BEGINNING	1.644	1,259
CASH, DEURINING	1,044	1,239
CASH, ENDING	\$ 2,158	\$ 1,644
	<del></del>	



### 17. SUBSEQUENT EVENTS:

Subsequent events have been evaluated through February 5, 2013, which is the date the financial statements were available to be issued.

### **INDEPENDENT AUDITORS' REPORT**

Shareholders and Board of Directors Muncy Bank Financial, Inc. and Subsidiary Muncy, Pennsylvania:

We have audited the accompanying consolidated financial statements of Muncy Bank Financial, Inc. (a Pennsylvania corporation) and Subsidiary (Company), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income and comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### Management's Responsibility for the Financial Statements

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

### **Auditors' Responsibility**

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

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

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

### **Opinion**

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

Larson, Kellett & Associates P.C.

Montoursville, Pennsylvania February 5, 2013

40 Choate Circle • Montoursville, PA 17754 Phone: (570) 368-2941 • Fax: (570) 368-3172

### **BOARD OF DIRECTORS**

Todd M. Arthur Daniel C. Berninger J. Howard Langdon Richard H. Lloyd Harold E. Lowe Gary M. Peck Robert M. Rabb Bonnie M. Tompkins David E. Wallis

### **HONORARY DIRECTORS**

Pauline R. Montgomery Jar

James L. Muffly, Sr.

Arlene R. Opp

### MUNCY BANK FINANCIAL, INC.

Daniel C. Berninger, President and Chief Executive Officer Craig W. Kremser, Senior Vice President David Mayer, Senior Vice President Rhonda L. Gingery, Treasurer Karen J. Brandis, Secretary Kimberly A. Wetherhold, Asst. Secretary

#### THE MUNCY BANK AND TRUST COMPANY

Daniel C. Berninger, President and Chief Executive Officer

Craig W. Kremser, Senior Vice President/CFO

David Mayer, Senior Vice President/Sales Division Manager

Kathlene M. Bower, Senior Vice President/Business Development

Rhonda L. Gingery, Vice President/Cashier

Margarethe Aderhold, Vice President/Trust Department Manager

Marcella A. Soverns, Vice President/Compliance Manager

Esther A. Houseknecht, Asst. VP/Senior Lending Officer

Doris E. Swartz, Asst. VP/Electronic Banking/Security

Brenda K. Bitler, Asst. Vice President/Finance Control Manager

Karen J. Brandis. Corporate Secretary/Human Resource Manager

Janet D. Schultz, Community Office Manager

Krista R. Dyer, Community Office Manager

Susan E. Tollackson, Community Office Manager

Ruth L. Schneider, Community Office Manager

Kimberly A. Feigles, Community Office Manager

Susan P. McConnell, Asst. Community Office Manager

Kathy K. Dincher, Asst. Community Office Manager

Diane L. Jordan, Asst. Community Office Manager

Linda L. Reeser, Collections Manager

Kimberly A. Wetherhold, Asst. Community Office Administrator

Heath D. Heiss, Customer Service Officer

Beth A. Wolvniec. Customer Service Officer

Steven N. Naylor, Registered Representative

Robert S. Helmrich, Jr., Registered Representative

Jason A. Fischer, Credit Analyst

Jo A. Langer, Muncy Head Teller

Candice A. Brown, Hughesville Head Teller

Molly K. Delany. Clarkstown Head Teller

Tricia C. Giazzon, Montoursville Head Teller

Randi K. Fogleman, Dewart Head Teller

Cheryl J. Frantz, Vault Teller

### **EMPLOYEES**

#### **FULL TIME**

Pamela D. Aderhold
Deborah L. Akers
Barbara J. Applegate
Adrienne E. Budman
Holly A. Clayton
Beth A. Cooley
D'Aracy D. Erb
Dorcas L. Fisher
Jamie A. Fry
Andrea R. Hulsizer

Kathy A. Stauffer
Nicole R. Stepp
Luke G. Temple
Katie B. Ulrich
Vanessa L. VanKirk

Adrienne E. Budman Holly A. Clayton Beth A. Cooley D'Aracy D. Erb Dorcas L. Fisher Jamie A. Fry Andrea R. Hulsizer Judith M. Houser Sheila K. Karschner Susan M. Keller Michele L. Leidhecker Sandra E. Little Jamie M. Livermore Jane A. Miller Kirsten C. Minier Jill S. Morrissey

Alicia M. Naugle

Teresa A. Oakes

Tammy J. Pennycoff Michelle A. Rohrbach

### PART TIME

Pamela J. Armstrong Danielle L. Bouse Connie P. Burfield Glenda E. Burgess Cynthia K. Craddock Erin D. Confer Tammy M. Felix Casey M. Fry Levi M. Geyer Connie J. Hamilton Mary M. Hoffman Karen L. Lander Debra L. Page Michelle A. Paisley DonnaJoy Perrotta Susan J. Sanders Karen E. Shoemaker Lori A. Snyder Tonia A. Stutzman Virginia O. Walter Stacey L. Wheeler

### **OFFICE LOCATIONS**

### **MUNCY**

Two North Main Street PO Box 179 Muncy PA 17756 (570) 546-2211

### **CLARKSTOWN**

Lowe's Plaza 2175 State Route 442 Clarkstown PA 17756 (570) 546-2226

### **MUNCY DRIVE THROUGH**

319 South Main Street Muncy PA 17756

### **HUGHESVILLE**

725 State Route 405 Hughesville PA 17737 (570) 584-5171

### **MONTOURSVILLE**

900 North Loyalsock Ave Montoursville PA 17754 (570) 368-1234

### **DEWART**

4880 State Route 44 Watsontown PA 17777 (570) 538-2200

toll free (877) 243-8919 24 Hour Telephone Access Banking (570) 546-9221 or toll free (877) 243-8916



# Muncy Bank Financial, Inc. and Subsidiary

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