

## **DIRECTORS**

Croghan Bancshares, Inc. The Croghan Colonial Bank

#### James E. Bowlus, Lead Director

President/Treasurer Fremont Candy & Cigar, Inc.

#### Michael D. Allen Sr.

Executive Vice President/General Manager International Metal Hose Company

#### James R. Faist

Retired

#### Claire F. Johansen

Owner

Lane of Dreams Farm, LLC

#### Stephen A. Kemper

Owner

Kemper Iron & Metal Company

#### Daniel W. Lease

Vice President Administration/CFO WT Holdings, LLC

#### Thomas W. McLaughlin

Vice President/CFO Underground Utilities, Inc.

#### Allan E. Mehlow

Chief Financial Officer
The Mosser Group/WMOG, Inc.

#### Rick M. Robertson

President/CEO

The Croghan Colonial Bank

#### Gary L. Zimmerman

Owner/Partner Swint-Reineck Company

## DIRECTORS EMERITI

Ted L. Hilty

Don W. Miller

Robert H. Moyer

J. Terrence Wolfe

### **OFFICERS**

Croghan Bancshares, Inc.

#### Rick M. Robertson

President/CEO

#### Thomas J. Elder Jr.

Vice President

#### Kendall W. Rieman

Vice President/Treasurer

#### Barry F. Luse

Vice President/Secretary

# SENIOR MANAGEMENT TEAM

The Croghan Colonial Bank

#### Rick M. Robertson

President/CEO

#### Thomas J. Elder Jr.

**Executive Vice President/CLO** 

### Kendall W. Rieman

**Executive Vice President/CFO** 

#### Stacy A. Cox

Senior Vice President/COO

#### Jeffrey L. Geary

Senior Vice President/Commercial Lending

#### Barry F. Luse

Senior Vice President/Trust Officer

#### Daniel N. Schloemer

Senior Vice President/Commercial Lending

#### Jodi A. Albright

Vice President/Retail Operations Manager

#### Charles T. Barteck

Vice President/Retail Sales Manager

#### Laura M. Whipple

Human Resource Manager

# CROGHAN BANCSHARES, INC.

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#### **AVAILABILITY OF MORE INFORMATION**

To obtain a free copy of the Corporation's Annual Report for the year ended December 31, 2012, or for other information, contact us by one of the methods noted below:

Croghan Bancshares, Inc.
Amy LeJeune
323 Croghan Street
Fremont, OH 43420
419-332-7301
888-276-4426
www.croghan.com

# A Message from CEO Rick Robertson

#### Highlights for 2012 include:

- Net income of \$4,843,000, which is our third year in a row of increased profitability
- Loan growth of \$19.3 million, which represents a 6.4% growth in the loan portfolio
- Cash dividends continued at \$0.32 per share on a quarterly basis with the 4<sup>th</sup> quarter dividend paid early for shareholder benefit. The normalized dividend of \$1.28 annually represents a 4.2% cash return on the year end closing price.

#### **Bank Profitability**

Net Income for 2012 totaled \$4,843,000, which compares favorably to \$4,754,000 for 2011 and \$4,024,000 for 2010. In this lower interest rate environment, both interest income and interest expense were lower in 2012 compared to 2011. Non-interest expenses increased in 2012 over 2011 due to a variety of factors, including larger size of the organization from the branch purchase, systems and technology costs to maintain and improve our ability to provide desired service levels, and some transaction costs from the branch purchase. Favorable changes were experienced in non-interest income, which increased 31.3% to \$4,553,000 in 2012 from \$3,468,000 in 2011, and a reduced provision for loan expense in 2012 compared to 2011.

#### **Loan Growth**

Growing the loan portfolio with quality assets is important for our continued success. Fortunately, we were able to have good loan growth in 2012, with the loan portfolio growing to \$321,277,000 at December 31, 2012, a \$19.3 million increase from December 31, 2011. All of this growth came from new production, not as a result of the branch acquisition.

#### **Stock Price and Dividend Payments**

Quarterly dividends were declared during 2012 at a rate of \$0.32 per share for each quarter. Due to general "fiscal cliff" concerns and the potential for tax increases at the time, our fourth quarter dividend was paid earlier than normal. The normalized annual dividend of \$1.28 per share represents a 4.2% cash return on the December 31, 2012 closing price of our stock of \$30.27. In general, our stock price varied between \$30.00 and \$35.00 per share for most of the year and is currently in the range of \$32.00 to \$33.00 per share as I write this letter. As we look back to 2010, our stock generally traded in the range of \$23.00 to \$26.00 per share. In 2011, the general trading range was \$24.00 to \$26.00 until the fourth quarter of 2011 when increases took place ending 2011 at \$29.00 per share. Clearly, there are numerous market factors that impact stock prices, but we are pleased with the positive movement over the past few years.

#### **Branch Purchase**

In my letter to you last year, I was very optimistic about the branch purchase we had recently completed. It provided us entry into the Tiffin and Seneca County market plus grew our Clyde and Fremont business. Now, a year later, we believe that with a year's worth of information this transaction has been good for the organization and we remain equally as optimistic as we were a year ago. During 2012, we also had challenges presented from this transaction. Operational items and cultural integration actually went very well. Probably the most significant challenge was a reduced Net Interest Margin. With a significant inflow of deposits, a low interest rate environment for quality investments, and the time it takes to restructure the deposit mix, the Net Interest Margin dropped during 2012. The future challenge is to rebuild this margin with loan growth and deposit mix management.

#### **Employees & Retirees**

So many employees have had a positive impact on The Croghan Colonial Bank over our history. It is with happiness for them that I would like to acknowledge recent retirements:

- Robert "Bob" Overmyer, VP, Deposit Administrator & Security Officer, retired on January 4, 2013 after 42 years of service.
- Coleen Miller, East Banking Center Relationship Manager, retired on December 31<sup>st</sup> after almost 45 years of service
- Elaine Blackmore, AVP & Private Banking Manager, retired on December 30<sup>th</sup> after almost 9 years of service.

In previous quarterly updates I mentioned several retired senior leaders who had passed away:

- Al Nichols, former President & Chairman of Croghan, passed away in June at age 93; 48 years of service.
- Former President Tom Hite had passed away in December 2011; 44 years of service.
- Jim Walter, SVP of Commercial Loans, passed away in March 2012; 42 years of service.

These individuals all played critical roles in the success of The Croghan Colonial Bank and they will be missed.

#### **Community Participation and Support**

Initially, I thought about listing those organizations, events, and/or programs supported in part by bank donations or employee participation and donations during the past year. The list immediately became too long for this letter and I would have certainly risked missing an important relationship. The bottom line is that I believe you would be proud of your bank if you were able to see the long list of community support and participation provided by your bank and our employees.

On a personal note, my wife Debbie and I had the wonderful opportunity to be the Chairmen of the Sandusky County United Way Campaign in 2012. This was an excellent way to learn more about numerous programs and we came away with tremendous respect for the amazing amount of volunteer support received and needed by important programs. Thanks to those, that by giving both time and money, helped improve our community.

In closing, we continue to focus our efforts to have The Croghan Colonial Bank be a top performer responding to the needs of our customers, our shareholders, our employees, and our communities. On behalf of the Board and our employees, thank you for your continuing support.

Very truly yours,

Rick M. Robertson

President and Chief Executive Officer

Red in Roberton

January 2013

## CROGHAN BANCSHARES, INC.

#### **DESCRIPTION OF THE CORPORATION**

Croghan Bancshares, Inc. ("Croghan"), an Ohio corporation, is a bank holding company incorporated in 1983 with \$630,952,000 in total assets as of December 31, 2012. Croghan owns all of the outstanding shares of The Croghan Colonial Bank ("the Bank"), an Ohio state-chartered bank incorporated in 1888 and headquartered in Fremont, Ohio.

The Bank offers a diverse range of commercial and retail banking services through its 14 banking centers located in Bellevue, Clyde, Custar, Fremont, Green Springs, Monroeville, Norwalk, Port Clinton, and Tiffin Ohio. Products are comprised of traditional banking services such as consumer, commercial, agricultural and real estate loans, personal and business checking accounts, savings accounts, time deposit accounts, safe deposit box services, and trust department services. Investment products bearing no FDIC insurance are offered through the Bank's Trust and Investment Services Division.

#### MARKET PRICE AND DIVIDENDS ON COMMON SHARES

Croghan's common shares are quoted on the OTC Bulletin Board under the symbol "CHBH." The following shows the range of high and low price quotations, as reported on the OTC Bulletin Board, for Croghan's common shares for each quarterly period during 2012 and 2011. OTC Bulletin Board quotations reflect inter-dealer prices, without mark-up, mark-down, or commission and may not necessarily represent actual transactions.

|                | 2012    |       | 20 <sup>-</sup> | 11    |  |
|----------------|---------|-------|-----------------|-------|--|
|                | Low     | High  | Low             | High  |  |
| First Quarter  | \$27.80 | 36.50 | \$23.75         | 25.48 |  |
| Second Quarter | 33.75   | 36.50 | 23.55           | 25.00 |  |
| Third Quarter  | 31.21   | 35.00 | 24.10           | 26.90 |  |
| Fourth Quarter | 30.27   | 33.49 | 24.50           | 29.00 |  |

Net income, basic net income per share data, and dividends declared by Croghan on its common shares during the past two years are as follows (dollars in thousands, except per share data):

| 2012                                                               | Net<br>income                            | Basic<br>net income<br>per share | Dividend<br>per share              |
|--------------------------------------------------------------------|------------------------------------------|----------------------------------|------------------------------------|
| First quarter Second quarter Third quarter Fourth quarter          | \$ 934<br>1,371<br>1,284<br><u>1,254</u> | .56<br>.82<br>.77<br><u>.74</u>  | \$ .32<br>.32<br>.32<br><u>.32</u> |
| Total                                                              | <u>\$4,843</u>                           | <u>2.89</u>                      | <u>\$1.28</u>                      |
| 2011                                                               | Net                                      | Basic<br>net income              | Dividend                           |
|                                                                    | income                                   | per share                        | per share                          |
| First quarter<br>Second quarter<br>Third quarter<br>Fourth quarter |                                          |                                  |                                    |

The ability of Croghan to declare and pay dividends on its common shares is dependent, in large part, on dividends received from the Bank. The ability of the Bank to pay dividends is subject to certain legal and regulatory limitations described in Note 18 to the consolidated financial statements of the Annual Report.

# CROGHAN BANCSHARES, INC. THREE YEAR SUMMARY OF SELECTED FINANCIAL DATA

|                                                                | Years ended December 31, |                 |                 |  |
|----------------------------------------------------------------|--------------------------|-----------------|-----------------|--|
|                                                                | 2012                     | 2011            | 2010            |  |
|                                                                | (Dollars in thou         | ısands, exce    | ept share data) |  |
| Statements of operations:                                      |                          |                 |                 |  |
| Total interest income                                          | \$21,059                 | \$21,622        | \$22,739        |  |
| Total interest expense                                         | 3,086                    | 3,355           | <u>5,085</u>    |  |
| Net interest income                                            | 17,973                   | 18,267          | 17,654          |  |
| Provision for loan losses                                      | <u>525</u>               | <u>775</u>      | <u>1,675</u>    |  |
| Net interest income, after provision for loan losses           | 17,448                   | 17,492          | 15,979          |  |
| Total non-interest income                                      | 4,553                    | 3,468           | 3,780           |  |
| Total non-interest expenses                                    | <u> 16,417</u>           | 15,008          | 14,732          |  |
| Income before federal income taxes                             | 5,584                    | 5,952           | 5,027           |  |
| Federal income taxes                                           | <u>741</u>               | <u>1,198</u>    | <u>1,003</u>    |  |
| Net income                                                     | <u>\$ 4,843</u>          | <u>\$ 4,754</u> | <u>\$ 4,024</u> |  |
| Per share of common stock:                                     |                          |                 |                 |  |
| Net income - Basic                                             | \$ 2.89                  | \$ 2.84         | \$ 2.38         |  |
| Net income - Diluted                                           | 2.88                     | 2.84            | 2.38            |  |
| Dividends                                                      | 1.28                     | 1.28            | 1.28            |  |
| Book value                                                     | 40.01                    | <u>37.58</u>    | <u>33.71</u>    |  |
| Average shares of common stock outstanding                     | <u>1,673,667</u>         | 1,673,775       | 1,692,307       |  |
| Year-end balances:                                             |                          |                 |                 |  |
| Loans, net                                                     | \$316,952                | \$297,187       | \$288,350       |  |
| Securities                                                     | 242,395                  | 229,126         | 144,623         |  |
| Total assets                                                   | 630,952                  | 629,651         | 489,727         |  |
| Deposits                                                       | 511,940                  | 501,837         | 384,157         |  |
| Stockholders' equity                                           | 67,164                   | 62,883          | <u>56,513</u>   |  |
| •                                                              |                          |                 |                 |  |
| Selected ratios:  Net yield on average interest-earning assets | 3.18%                    | 3.99%           | 4.01%           |  |
| Return on average assets                                       | .77                      | .94             | .82             |  |
| Return on average stockholders' equity                         | 7.40                     | 7.97            | 7.03            |  |
| Net loan charge-offs as a percent of average                   |                          |                 |                 |  |
| outstanding net loans                                          | .32                      | .34             | .38             |  |
| Allowance for loan losses as a percent of                      |                          |                 |                 |  |
| year-end loans                                                 | 1.35                     | 1.58            | 1.69            |  |
| Stockholders' equity as a percent of total                     |                          |                 |                 |  |
| year-end assets                                                | 10.64                    | 9.99            | 11.54           |  |
|                                                                |                          |                 |                 |  |
| Number of stockholders of record                               | 688                      | 689             | 693             |  |
| Number of full-time equivalent employees                       | 167                      | 171             | 150             |  |
| • •                                                            |                          |                 |                 |  |

#### Notes:

<sup>1)</sup> Financial data for 2012 and 2011 includes the impact of the December 2011 acquisition of four branches of The Home Savings and Loan Company of Youngstown, Ohio.

CliftonLarsonAllen LLP www.cliftonlarsonallen.com



#### **Independent Auditors' Report**

Stockholders and Board of Directors Croghan Bancshares, Inc. Fremont, Ohio

We have audited the accompanying consolidated financial statements of Croghan Bancshares, Inc. and its subsidiary, which comprise the consolidated balance sheets, as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012, 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 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 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 financial statements based on our audits. We conducted our 2012 audit in accordance with auditing standards generally accepted in the United States of America and we conducted our 2011 and 2010 audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the 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 financial statements.

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

Stockholders and Board of Directors Croghan Bancshares, Inc.

### Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Croghan Bancshares, Inc. and its subsidiary as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

Clifton Larson Allen LLP

Toledo, Ohio March 12, 2013

# CROGHAN BANCSHARES, INC. CONSOLIDATED BALANCE SHEETS

| ASSETS                                                                                                                                                                                                                                                                            | Deceml<br>2012<br>(Dollars in thousand                | oer 31,<br>2011<br>ds, except par value)              |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------|-------------------------------------------------------|
| CASH AND CASH EQUIVALENTS                                                                                                                                                                                                                                                         | \$ 31,216                                             | \$ 60,093                                             |
| SECURITIES  Available-for-sale, at fair value  Restricted stock                                                                                                                                                                                                                   | 238,221<br><u>4,174</u>                               | 225,282<br>3,844                                      |
| Total securities                                                                                                                                                                                                                                                                  | 242,395                                               | 229,126                                               |
| LOANS Less: Allowance for loan losses                                                                                                                                                                                                                                             | 321,277<br>4,325                                      | 301,965<br>4,778                                      |
| Net loans                                                                                                                                                                                                                                                                         | <u>316,952</u>                                        | 297,187                                               |
| PREMISES AND EQUIPMENT, NET CASH SURRENDER VALUE OF LIFE INSURANCE GOODWILL CORE DEPOSIT INTANGIBLE ASSETS, NET ACCRUED INTEREST RECEIVABLE OTHER REAL ESTATE OWNED, net of valuation allowance of \$33,000 in 2012 and \$165,000 in 2011                                         | 7,514<br>11,087<br>14,629<br>927<br>2,591             | 8,215<br>10,766<br>14,675<br>1,327<br>2,485           |
| OTHER ASSETS                                                                                                                                                                                                                                                                      | <u>2,346</u>                                          | <u>3,900</u>                                          |
| TOTAL ASSETS                                                                                                                                                                                                                                                                      | <u>\$630,952</u>                                      | <u>\$629,651</u>                                      |
| LIABILITIES AND STOCKHOLDERS' EQUITY                                                                                                                                                                                                                                              |                                                       |                                                       |
| LIABILITIES Deposits: Demand, non-interest bearing Savings, NOW, and Money Market deposits Time Total deposits                                                                                                                                                                    | \$ 89,530<br>261,860<br><u>160,550</u><br>511,940     | \$ 77,056<br>231,182<br><u>193,599</u><br>501,837     |
| Federal funds purchased and securities sold under repurchase agreements Borrowed funds Dividends payable Other liabilities Total liabilities                                                                                                                                      | 32,344<br>15,199<br>-<br><u>4,305</u><br>563,788      | 40,861<br>18,500<br>535<br>                           |
| STOCKHOLDERS' EQUITY Common stock, \$12.50 par value. Authorized 6,000,000 shares; issued 1,914,109 shares Surplus Retained earnings Accumulated other comprehensive income Treasury stock, 235,479 shares in 2012 and 240,729 shares in 2011, at cost Total stockholders' equity | 23,926<br>118<br>45,361<br>5,843<br>(8,084)<br>67,164 | 23,926<br>179<br>42,662<br>4,341<br>(8,225)<br>62,883 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY                                                                                                                                                                                                                                        | <u>\$630,952</u>                                      | <u>\$629,651</u>                                      |

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

# CROGHAN BANCSHARES, INC. CONSOLIDATED STATEMENTS OF OPERATIONS

|                                                                                                                                                         | 2012                                  | nded Decemb<br>2011                       | 2010                                 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------|-------------------------------------------|--------------------------------------|
|                                                                                                                                                         | (Dollars in thous                     | sands, except                             | per share data)                      |
| INTEREST INCOME Loans, including fees Securities:                                                                                                       | \$16,797                              | \$16,632                                  | \$18,156                             |
| Obligations of U.S. Government agencies and corporations Obligations of states and political subdivisions Other Deposits in other banks                 | 1,033<br>3,006<br>198<br>25           | 2,536<br>2,254<br>188<br>12               | 2,640<br>1,703<br>215<br>25          |
| Total interest income                                                                                                                                   | 21,059                                | 21,622                                    | 22,739                               |
|                                                                                                                                                         | 21,033                                | 21,022                                    | 22,709                               |
| INTEREST EXPENSE Deposits Other borrowings                                                                                                              | 2,323<br><u>763</u>                   | 2,620<br>735                              | 3,728<br>                            |
| Total interest expense                                                                                                                                  | 3,086                                 | 3,355                                     | <u>5,085</u>                         |
| Net interest income                                                                                                                                     | 17,973                                | 18,267                                    | 17,654                               |
| PROVISION FOR LOAN LOSSES                                                                                                                               | <u>525</u>                            | 775                                       | <u>1,675</u>                         |
| Net interest income, after provision for loan losses                                                                                                    | <u>17,448</u>                         | 17,492                                    | <u> 15,979</u>                       |
| NON-INTEREST INCOME Trust income Service charges on deposit accounts Gain on sale of loans Loss on security impairment Gain on sale of securities Other | 1,167<br>1,780<br>246<br>-<br>311<br> | 1,076<br>1,444<br>115<br>(394)<br>149<br> | 1,026<br>1,460<br>282<br>-<br>11<br> |
| Total non-interest income                                                                                                                               | 4,553                                 | 3,468                                     | 3,780                                |
| NON-INTEREST EXPENSES Salaries, wages, and employee benefits Occupancy of premises Amortization of core deposit intangible assets Other operating       | 8,922<br>961<br>400<br><u>6,134</u>   | 8,384<br>851<br>58<br>5,715               | 8,271<br>838<br>58<br>5,565          |
| Total non-interest expenses                                                                                                                             | <u>16,417</u>                         | 15,008                                    | <u>14,732</u>                        |
| Income before federal income taxes                                                                                                                      | 5,584                                 | 5,952                                     | 5,027                                |
| FEDERAL INCOME TAXES                                                                                                                                    | <u>741</u>                            | 1,198                                     | <u>1,003</u>                         |
| NET INCOME                                                                                                                                              | <u>\$ 4,843</u>                       | <u>\$ 4,754</u>                           | <u>\$ 4,024</u>                      |
| NET INCOME PER SHARE<br>Basic                                                                                                                           | <u>\$ 2.89</u>                        | <u>\$ 2.84</u>                            | <u>\$ 2.38</u>                       |
| Diluted                                                                                                                                                 | <u>\$ 2.88</u>                        | <u>\$ 2.84</u>                            | <u>\$ 2.38</u>                       |

# CROGHAN BANCSHARES, INC. CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

|                                                                                       | Years ended December 31, |                |                |
|---------------------------------------------------------------------------------------|--------------------------|----------------|----------------|
|                                                                                       | 2012                     | 2011           | 2010           |
|                                                                                       | (Dolla                   | ars in thousa  | nds)           |
| NET INCOME                                                                            | <u>\$4,843</u>           | <u>\$4,754</u> | \$4,024        |
| OTHER COMPREHENSIVE INCOME Unrealized gains (losses) on available-for-sale securities | 2,587                    | 5,958          | (802)          |
| Reclassification adjustments for securities gains<br>included in income               | (311)                    | (149)          | (11)           |
| Net unrealized gains (losses)                                                         | 2,276                    | 5,809          | (813)          |
| Income tax effect                                                                     | <u>774</u>               | 1,975          | (276)          |
| Other comprehensive income (loss)                                                     | 1,502                    | 3,834          | (537)          |
| TOTAL COMPREHENSIVE INCOME                                                            | <u>\$6,345</u>           | \$8,588        | <u>\$3,487</u> |

# CROGHAN BANCSHARES, INC. CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years ended December 31, 2012, 2011, and 2010

|                                                                                                                                                                            | Common<br>stock       | Surplus          | Retained earnings               | Accumulated other comprehensive income | Treasury<br>stock  | Total                                |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|------------------|---------------------------------|----------------------------------------|--------------------|--------------------------------------|
|                                                                                                                                                                            |                       | (Dollars         | in thousand                     | s, except per sha                      | re data)           |                                      |
| BALANCE AT DECEMBER 31, 2009                                                                                                                                               | \$23,926              | \$179            | \$38,187                        | \$1,044                                | \$(7,209)          | \$56,127                             |
| Net income<br>Other comprehensive loss<br>Purchase of 37,497 treasury shares<br>Cash dividends declared, \$1.28 per share                                                  | -<br>-<br>-<br>-      | -<br>-<br>-<br>- | 4,024<br>-<br>-<br>-<br>(2,161) | (537)<br>-<br>-                        | -<br>(940)<br>-    | 4,024<br>(537)<br>(940)<br>(2,161)   |
| BALANCE AT DECEMBER 31, 2010                                                                                                                                               | 23,926                | 179              | 40,050                          | 507                                    | (8,149)            | 56,513                               |
| Net income<br>Other comprehensive income<br>Purchase of 3,000 treasury shares<br>Cash dividends declared, \$1.28 per share                                                 | -<br>-<br>-<br>-      | -<br>-<br>-<br>- | 4,754<br>-<br>-<br>-<br>(2,142) | 3,834<br>-<br>                         | -<br>(76)          | 4,754<br>3,834<br>(76)<br>(2,142)    |
| BALANCE AT DECEMBER 31, 2011                                                                                                                                               | 23,926                | 179              | 42,662                          | 4,341                                  | (8,225)            | 62,883                               |
| Net income Other comprehensive income Issuance of restricted stock (5,250 shares from treasury) Stock-based compensation expense Cash dividends declared, \$1.28 per share | -<br>-<br>-<br>-<br>- | (141)<br>80      | 4,843<br>-<br>-<br>-<br>(2,144) | -<br>1,502<br>-<br>-<br>-              | -<br>141<br>-<br>- | 4,843<br>1,502<br>-<br>80<br>(2,144) |
| BALANCE AT DECEMBER 31, 2012                                                                                                                                               | <u>\$23,926</u>       | <u>\$118</u>     | <u>\$45,361</u>                 | <u>\$5,843</u>                         | <u>\$(8,084</u> )  | <u>\$67,164</u>                      |

# CROGHAN BANCSHARES, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS

| CASH FLOWS FROM OPERATING ACTIVITIES                       | Years ended December 31,<br>2012 2011 201<br>(Dollars in thousands) |                      |   | 2010      |    |                 |
|------------------------------------------------------------|---------------------------------------------------------------------|----------------------|---|-----------|----|-----------------|
|                                                            | \$                                                                  | 4,843                |   | \$ 4,754  | \$ | 4,024           |
| Net income Adjustments to reconcile net income to net cash | Φ                                                                   | 4,043                |   | Ф 4,754   | Ф  | 4,024           |
| provided by operating activities:                          |                                                                     |                      |   |           |    |                 |
| Depreciation and amortization                              |                                                                     | 629                  |   | 823       |    | 846             |
| Provision for loan losses                                  |                                                                     | 525                  |   | 775       |    | 1,675           |
| Deferred federal income taxes                              |                                                                     | 206                  |   | (55)      |    | (303)           |
| Gain on sale of loans                                      |                                                                     | (246)                | ١ | (115)     |    | (282)           |
| Net loss on sale or write-down of other                    |                                                                     | (210)                | , | (110)     |    | (202)           |
| real estate owned                                          |                                                                     | 20                   |   | 141       |    | 30              |
| Increase in cash value of life insurance                   |                                                                     | (321)                | ١ | (301)     |    | (411)           |
| Gain on life insurance settlement                          |                                                                     | -                    | ' | (204)     |    | -               |
| Net amortization of security premiums                      |                                                                     |                      |   | (201)     |    |                 |
| and discounts                                              |                                                                     | 6,425                |   | 2,356     |    | 1,196           |
| Stock-based compensation expense                           |                                                                     | 80                   |   | -         |    | -               |
| Provision for deferred compensation                        |                                                                     | 11                   |   | _         |    | 2               |
| Gain on sale of securities                                 |                                                                     | (311)                | ) | (149)     |    | (11)            |
| Loss on security impairment                                |                                                                     | -                    | , | 394       |    | -               |
| Proceeds from sale of loans, net of originations           |                                                                     | 181                  |   | 76        |    | 201             |
| Increase in accrued interest receivable                    |                                                                     | (106)                | ) | (444)     |    | (123)           |
| Increase (decrease) in other assets                        |                                                                     | 253                  | ' | (803)     |    | (116)           |
| Increase (decrease) in other liabilities                   |                                                                     | (441)                | ) | 946       |    | (345)           |
|                                                            |                                                                     |                      |   |           |    |                 |
| Net cash provided by operating activities                  | _                                                                   | 11,748               |   | 8,194     | _  | 6,383           |
| CASH FLOWS FROM INVESTING ACTIVITIES                       |                                                                     |                      |   |           |    |                 |
| Proceeds from maturities of securities                     |                                                                     | 86,240               |   | 36,342    |    | 24.002          |
| Proceeds from sales of available-for-sale securities       |                                                                     | 7,858                |   | 4,005     |    | 24,093<br>1,996 |
| Proceeds from sale of other real estate owned              |                                                                     | 1,757                |   | 1,125     |    | 1,738           |
| Proceeds from disposal of premises                         |                                                                     | 1,737                |   | 1,123     |    | 1,730           |
| Proceeds from life insurance                               |                                                                     | 1,097                |   | -         |    | -               |
| Purchases of available-for-sale securities                 | /1                                                                  | 10,875)              |   | (121,643) |    | (62,573)        |
| Proceeds from branch acquisition, net of final             | (1                                                                  | 10,673)              | ' | (121,043) |    | (02,373)        |
| settlement payment                                         |                                                                     | (1,026)              | ١ | 83,496    |    | _               |
| Purchase of restricted stock                               |                                                                     | (330)                |   | -         |    | _               |
| Net decrease (increase) in loans                           | (                                                                   | (21,446)<br>(21,446) |   | 10,000    |    | 29,145          |
| Additions to premises and equipment                        | '                                                                   | (225)                |   | (544)     |    | (515)           |
| Additions to premises and equipment                        |                                                                     | (223)                | ' | (344)     | _  | (313)           |
| Net cash provided by (used in)                             |                                                                     |                      |   |           |    |                 |
| investing activities                                       | (                                                                   | (36,776)             | ) | 12,781    |    | (6,116)         |

# CROGHAN BANCSHARES, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

|                                                                                         | Years ended December 31,                     |                  |                  |
|-----------------------------------------------------------------------------------------|----------------------------------------------|------------------|------------------|
|                                                                                         | 2012                                         | 2011             | 2010             |
|                                                                                         | (Do                                          | llars in thous   | sands)           |
| CASH FLOWS FROM FINANCING ACTIVITIES                                                    | •                                            |                  | ,                |
| Net increase in deposits                                                                | \$ 10,648                                    | \$ 6,608         | \$ 13,438        |
| Increase (decrease) in federal funds purchased and                                      |                                              | •                | •                |
| securities sold under repurchase agreements                                             | (8,517)                                      | 19,872           | 4,614            |
| Borrowed funds:                                                                         | , ,                                          |                  | •                |
| Proceeds                                                                                | -                                            | 6,000            | -                |
| Repayments                                                                              | (3,301)                                      | (13,000)         | (10,000)         |
| Cash dividends paid                                                                     | (2,679)                                      | (2,142)          | (2,174)          |
| Purchase of treasury stock                                                              | -                                            | (76)             | (940)            |
| Payment of deferred compensation                                                        | -                                            | - ′              | `(73)            |
| ·                                                                                       |                                              |                  |                  |
| Net cash provided by (used in)                                                          |                                              |                  |                  |
| financing activities                                                                    | (3,849)                                      | 17,262           | 4,865            |
| •                                                                                       |                                              |                  |                  |
| NET INCREASE (DECREASE) IN CASH AND                                                     |                                              |                  |                  |
| CASH EQUIVALENTS                                                                        | (28,877)                                     | 38,237           | 5,132            |
|                                                                                         |                                              |                  |                  |
| CASH AND CASH EQUIVALENTS AT                                                            |                                              |                  |                  |
| BEGINNING OF YEAR                                                                       | <u>60,093</u>                                | <u>21,856</u>    | <u>16,724</u>    |
|                                                                                         |                                              |                  |                  |
| CASH AND CASH EQUIVALENTS                                                               |                                              |                  |                  |
| AT END OF YEAR                                                                          | <u>\$ 31,216</u>                             | <u>\$ 60,093</u> | <u>\$ 21,856</u> |
| OURDI EMENTAL DIGGLOCUES                                                                |                                              |                  |                  |
| SUPPLEMENTAL DISCLOSURES                                                                |                                              |                  |                  |
| Cash paid during the year for:                                                          | Φ 0.007                                      | Φ 0.570          | <b>A O O 1 1</b> |
| Interest                                                                                | <u>\$ 3,097</u>                              | <u>\$ 3,572</u>  | <u>\$ 6,314</u>  |
| Fadaval income tayon                                                                    | Ф 570                                        | Ф 4.040          | Ф 1011           |
| Federal income taxes                                                                    | <u>\$ 579</u>                                | <u>\$ 1,210</u>  | <u>\$ 1,641</u>  |
| Non each operating activities:                                                          |                                              |                  |                  |
| Non-cash operating activities:                                                          |                                              |                  |                  |
| Change in deferred income taxes on net unrealized gain on available-for-sale securities | ¢ 774                                        | ¢ 1075           | <u>ቀ</u> (276)   |
| gain on available-for-sale securities                                                   | <u>\$ 774</u>                                | <u>\$ 1,975</u>  | <u>\$ (276)</u>  |
| Non-cash investing activity:                                                            |                                              |                  |                  |
| Change in net unrealized gain on                                                        |                                              |                  |                  |
| available-for-sale securities                                                           | \$ 2,27 <u>6</u>                             | \$ 5,809         | \$ (813)         |
| available-101-3ale 3ecultue3                                                            | <u>Ψ                                    </u> | Ψ 5,009          | <u>Ψ (010)</u>   |
| Non-cash operating and investing activity:                                              |                                              |                  |                  |
| Transfer of loans to other real estate owned                                            | \$ 1,19 <u>5</u>                             | <b>\$ 1,700</b>  | \$ 881           |
| Transier of loans to other real estate owned                                            | <u>Ψ 1,133</u>                               | $\psi$ 1,700     | <del>ψ 001</del> |

## CROGHAN BANCSHARES, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Croghan Bancshares, Inc. (the "Corporation") was incorporated on September 27, 1983 in the State of Ohio. The Corporation is a bank holding company and has one wholly-owned subsidiary, The Croghan Colonial Bank (the "Bank"). The Corporation, through its subsidiary, operates in one industry segment, the commercial banking industry. The Bank, an Ohio chartered bank organized in 1888, has its main office in Fremont, Ohio and has branch offices located in Bellevue, Clyde, Custar, Fremont, Green Springs, Monroeville, Norwalk, Port Clinton, and Tiffin Ohio. The Bank's primary source of revenue is providing loans to clients primarily located in Sandusky County, Seneca County, Ottawa County, Wood County, and the northwest portion of Huron County, which includes Bellevue, Monroeville, and Norwalk. Such clients are predominantly small and middle-market businesses and individuals.

Significant accounting policies followed by the Corporation are presented below.

#### **Use of Estimates in Preparing Financial Statements**

In preparing consolidated financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during each reporting period. Actual results could differ from those estimates. The most significant estimates susceptible to significant change in the near term relate to the determination of the allowance for loan losses, valuation of goodwill, fair value of securities, and other financial instruments.

#### **Principles of Consolidation**

The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

The Bank established a trust department in 1990 and the assets held by the Bank in fiduciary or agency capacities for its clients are not included in the consolidated balance sheets as such items are not assets of the Bank.

#### **Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold which mature overnight or within four days.

#### **Restrictions on Cash**

The Bank was required to have \$275,000 of non-interest bearing cash on hand or on deposit with the Federal Reserve Bank to meet regulatory reserve and clearing requirements at December 31, 2012 and 2011.

#### **Securities**

The Bank has designated all securities as available-for-sale. Such securities are carried at fair value, with unrealized gains and losses, net of applicable income taxes, on such securities recognized as a separate component of stockholders' equity.

The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest income from securities, principally using the interest method over the terms of the securities. Declines in the fair value of securities below their cost that are deemed to be other than temporary impaired ("OTTI") are reflected in earnings as realized losses. Management evaluates securities for OTTI at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to (1) the intent to sell the investment securities and whether it is more likely than not that the Corporation will be required to sell the investment securities prior to recovery, (2) the length of time and extent to which the fair value has been less than cost, and (3) the financial condition and near-term prospects of the issuer. Due to potential changes in conditions, it is at least reasonably possible that changes in management's assessment of OTTI will occur in the near term and that such changes could be material to the amounts reported in the Corporation's consolidated financial statements.

Restricted stock consists primarily of Federal Home Loan Bank of Cincinnati and Federal Reserve Bank of Cleveland stock. Such securities are carried at cost and evaluated for impairment on an annual basis.

Gains and losses on sales of securities are recorded on the trade date, using the specific identification method, and are included in non-interest income.

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

#### Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are stated at their outstanding principal balances, adjusted for charge-offs, the allowance for loan losses, and any deferred loan fees or costs on originated loans. Interest is accrued on the unpaid principal balance. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan.

The accrual of interest on real estate and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Personal loans are typically charged-off no later than 120 days past due and credit card loans are typically charged-off no later than 180 days past due. All interest accrued but not collected for loans that are placed on nonaccrual or charged-off is reversed against interest income. The interest on nonaccrual loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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

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

The allowance consists of specific, general and secondary components. For loans that are classified as impaired, a specific reserve is established when the discounted cash flow (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers classified (i.e., substandard or special mention) loans which are not impaired, as well as non-classified loans and is generally based on historical loss experience adjusted for qualitative factors. The secondary component is maintained to cover economic and other external factors that could affect management's estimate of probable losses and considers the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Under certain circumstances, the Bank may provide borrowers relief through loan restructurings. A restructuring of debt constitutes a troubled debt restructuring (TDR) if the Bank, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Concessions may include reduction of interest rates, extension of maturity dates, forgiveness of principal or interest due, or acceptance of other assets in full or partial satisfaction of the debt. TDR loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment, as previously described. TDR loans that have performed as agreed under the restructured terms for a period of 12 months or longer may cease to be reported as a TDR loan. However, the loan continues to be individually evaluated for impairment.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential mortgage loans for impairment disclosures.

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

#### **Premises and Equipment**

Premises and equipment is stated at cost, less accumulated depreciation. Upon the sale or disposition of the assets, the difference between the depreciated cost and proceeds is charged or credited to income. Depreciation is determined based on the estimated useful lives of the individual assets (typically 20 to 40 years for buildings and 3 to 10 years for equipment) and is computed primarily using the straight-line method.

#### **Cash Surrender Value of Life Insurance**

Cash surrender value of life insurance is carried at the cash value of the underlying policies. Income on the investments in the policies, net of insurance costs, is recorded as non-interest income.

#### Goodwill, Core Deposit Intangible, and Other Intangible Assets

Goodwill resulting from the 1996 purchase of Union Bancshares Corp., the 2005 purchase of The Custar State Bank, and the 2011 purchase of four branches from The Home Savings and Loan Company of Youngstown, Ohio ("HSL") are tested for impairment at least annually to determine if an impairment loss has occurred. The core deposit intangible asset arising from the 2005 purchase of The Custar State Bank was amortized over an eight-year period on a straight-line basis through December 31, 2012, and the core deposit intangible asset arising from the 2011 HSL branch acquisition described in Note 3 is being amortized over ten years using the sum of digits amortization method.

Estimated future amortization of core deposit intangible assets is as follows: 2013, \$272,000; 2014, \$211,000; 2015, \$159,000; 2016, \$115,000; 2017, \$78,000; and \$92,000 thereafter. The fair value adjustment of time deposits acquired in the HSL transaction is being accreted on a straight-line basis over two years with \$551,000 to be recognized in 2013. The loan discount resulting from the HSL transaction is being accreted to income over a five-year period on a straight-line basis with \$39,000 expected to be recognized annually through 2016.

#### **Other Real Estate Owned**

Assets acquired through or in lieu of foreclosure are initially recorded at fair value, less estimated costs to sell, and any loan balance in excess of fair value is charged to the allowance for loan losses. Subsequent valuations are periodically performed and any further write-downs are included in other operating expenses, as are gains or losses upon sale and expenses related to maintenance of the properties.

#### Servicing

Mortgage servicing rights are recognized as an asset when acquired through sale of loans. Capitalized servicing rights are reported in other assets and amortized to expense in proportion to, and over the period of, the estimated future net servicing income of the underlying loans. Mortgage servicing rights are evaluated for impairment based upon the estimated fair value of the rights as compared to amortized cost. Fair value is determined based upon estimated discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance to the extent that fair value is less than the capitalized amount.

Servicing fee income is recorded for fees earned for servicing loans and is included in other operating income, net of amortization of mortgage servicing rights.

#### **Off-Balance Sheet Credit Related Financial Instruments**

In the ordinary course of business, the Bank has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

#### **Transfers of Financial Assets**

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

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The transfer of a participating interest in an entire financial asset must also meet the definition of a participating interest. A participating interest in a financial asset has all of the following characteristics: (1) from the date of transfer, it must represent a proportionate (pro rata) ownership interest in the financial asset, (2) from the date of transfer, all cash flows received, except any cash flows allocated as any compensation for servicing or other services performed, must be divided proportionately among participating interest holders in the amount equal to their share ownership, (3) the rights of each participating interest holder must have the same priority, and (4) no party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

#### **Supplemental Retirement Benefits**

Annual provisions are made for the estimated liability for accumulated supplemental retirement benefits under agreements with various officers and employees. These provisions are determined based on the terms of the agreements, as well as certain assumptions including estimated service periods and discount rates.

#### **Advertising Costs**

All advertising costs are expensed as incurred.

#### **Federal Income Taxes**

Deferred income taxes are provided on temporary differences between financial statement and income tax reporting. Temporary differences are differences between the amounts of assets and liabilities reported for financial statement purposes and their tax bases. Deferred tax assets are recognized for temporary differences that will be deductible in future years' tax returns and for operating loss and tax credit carryforwards. Deferred tax assets are reduced by a valuation allowance if it is deemed more likely than not that some or all of the deferred tax assets will not be realized. Deferred tax liabilities are recognized for temporary differences that will be taxable in future years' tax returns. Benefits from tax positions taken or expected to be taken in a tax return are not recognized if the likelihood that the tax position would be sustained upon examination by a taxing authority is considered to be 50% or less. Interest and penalties resulting from the filing of income tax returns is a component of income tax expenses.

The Bank is not currently subject to state and local income taxes.

#### **Comprehensive Income**

Recognized revenue, expenses, gains and losses are included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

#### **Per Share Data**

Basic net income per share is computed based on the weighted average number of shares of common stock outstanding during each year. Diluted net income per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be used by the Corporation relate solely to outstanding stock options and are determined using the treasury stock method.

The weighted average number of shares outstanding for the years ended December 31, 2012, 2011, and 2010 are as follows:

|         | 2012             | 2011             | 2010             |
|---------|------------------|------------------|------------------|
| Basic   | <u>1,673,667</u> | <u>1,673,775</u> | <u>1,692,307</u> |
| Diluted | <u>1,681,082</u> | <u>1,673,775</u> | 1,692,307        |

Dividends per share are based on the number of shares outstanding at the declaration date.

#### **Subsequent Events**

Management evaluated subsequent events through March 12, 2013, the date the consolidated financial statements were available to be issued. Events or transactions occurring after December 31, 2012, but prior to March 12, 2013, that provided additional evidence about conditions that existed at December 31, 2012, have been recognized in the consolidated financial statements for the year ended December 31, 2012. Events or transactions that provided evidence about conditions that did not exist at December 31, 2012, but arose before the consolidated financial statements were available to be issued, have not been recognized in the consolidated financial statements for the year ended December 31, 2012.

#### **NOTE 2 - NEW ACCOUNTING PRONOUNCEMENTS**

In May 2011, The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-04, Fair Value Measurement, amending Accounting Standards Codification (ASC) Topic 820 which eliminates terminology differences between U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) on the measurement of fair value and related fair value disclosures. While largely consistent with existing fair value measurement principles and disclosures, the changes were made as part of the continuing efforts to converge GAAP and IFRS. ASU 2011-04 was adopted effective January 1, 2012, but did not have any impact on the Corporation's financial position or results of operations.

In June 2011, FASB issued ASU 2011-05, *Comprehensive Income*, amending ASC Topic 220 to require that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, the guidance requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of stockholders' equity was eliminated. The amendments in ASU 2011-05 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income.

The Corporation adopted ASU-2011-05 for the first quarter of 2012 and has elected to present the components of other comprehensive income in a separate statement. The adoption of ASU 2011-05 did not have any impact on the Corporation's financial position or results of operations.

In December 2011, FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, amending ASC Topic 210 requiring an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendment is effective for periods beginning on or after January 1, 2013. The Corporation has not yet determined what, if any, impact the adoption of ASU 2011-011 will have on its consolidated financial statements.

In July 2012, FASB issued ASU 2012-02, *Intangibles – Goodwill and Other*, amending ASC Topic 350 to simplify how an entity tests indefinite-lived intangible assets other than goodwill for impairment and to improve consistency in impairment testing guidance among long-lived asset categories. The amendment permits an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset other than goodwill is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test. The amendment is effective for impairment tests performed for fiscal years beginning after September 15, 2012. Management does not expect ASU 2012-02 will have any impact on the Corporation's consolidated financial statements.

#### **NOTE 3 - BRANCH ACQUISITION**

On August 31, 2011, the Bank entered into an agreement to purchase four branch offices of The Home Savings and Loan Company of Youngstown, Ohio ("HSL"), located in Fremont, Clyde, and Tiffin, Ohio. Under the terms of the agreement, the Bank assumed all related deposits and purchased the related branch premises and certain loans. The transaction was completed on December 16, 2011, with assets acquired and deposits assumed being recorded at their estimated fair values as follows (dollars in thousands):

| Cash                                           | \$ 83,398        |
|------------------------------------------------|------------------|
| Loans                                          | 21,503           |
| Bank premises and equipment                    | 1,801            |
| Goodwill                                       | 4,245            |
| Core deposit intangible asset                  | 1,269            |
| Other assets                                   | 66               |
| Total assets acquired                          | <u>\$112,282</u> |
| Deposits assumed                               | \$111,075        |
| Other liabilities, including payable to seller | 1,207            |
| Total liabilities assumed                      | <u>\$112,282</u> |

#### NOTE 3 - BRANCH ACQUISITION (CONTINUED)

The operating results of the acquired branches, subsequent to December 16, 2011, are included in the Corporation's consolidated financial statements.

Other liabilities include a payable to seller, estimated at December 31, 2011 to be \$1,075,000 and representing the estimated change in the amounts of certain assets acquired and liabilities assumed between the initial "draft" settlement and the final settlement. Under the terms of the agreement, a final closing statement was prepared by HSL subsequent to closing and received by the Bank on January 15, 2012. On March 12, 2012, the Bank made a payment of \$1,026,000 as final settlement for changes occurring between the draft settlement and final settlement. The final settlement included a charge of \$46,000 to previously recorded goodwill.

Goodwill arising from the acquisition represents additional consideration paid for the benefit of expected synergies, revenue growth, and future market development. These benefits are not separately recognizable from goodwill because they do not meet the recognition requirement for identifiable intangible assets. Goodwill arising from the acquisition is being amortized for tax purposes on a straight-line basis over a 15 year period.

Cash received from the transaction was primarily invested in the Bank's securities portfolio and is expected to be used to fund anticipated loan growth.

#### **NOTE 4 - CASH AND CASH EQUIVALENTS**

Cash and cash equivalents as of December 31, 2012 and 2011 were as follows (dollars in thousands):

|                                                                     | 2012            | 2011                      |
|---------------------------------------------------------------------|-----------------|---------------------------|
| Cash and due from banks<br>Interest-bearing deposits in other banks | \$19,388<br>    | \$21,787<br><u>38,306</u> |
| Total                                                               | <u>\$31,216</u> | <u>\$60,093</u>           |

#### **NOTE 5 - SECURITIES**

The amortized cost and fair value of securities as of December 31, 2012 and 2011 were as follows (dollars in thousands):

|                                | 2                | 012              | 2011             |            |  |
|--------------------------------|------------------|------------------|------------------|------------|--|
|                                | Amortized        | Fair             | Amortized        | Fair       |  |
|                                | cost             | value            | cost             | value      |  |
| Available-for-sale:            |                  |                  |                  |            |  |
| Obligations of U.S. Government |                  |                  |                  |            |  |
| agencies and corporations      | \$129,591        | \$131,990        | \$135,929        | \$137,244  |  |
| Obligations of states and      |                  |                  |                  |            |  |
| political subdivisions         | 99,427           | 105,881          | 82,426           | 87,688     |  |
| Other                          | <u>350</u>       | <u>350</u>       | <u>350</u>       | <u>350</u> |  |
| Total available-for-sale       | 229,368          | 238,221          | 218,705          | 225,282    |  |
| Restricted stock               | 4,174            | 4,174            | 3,844            | 3,844      |  |
| Total                          | <u>\$233,542</u> | <u>\$242,395</u> | <u>\$222,549</u> | \$229,126  |  |

#### NOTE 5 - SECURITIES (CONTINUED)

Total

A summary of gross unrealized gains and losses on securities at December 31, 2012 and 2011 follows (dollars in thousands):

| ,                                                                                        | 2                            | 2011                          |                              |                               |
|------------------------------------------------------------------------------------------|------------------------------|-------------------------------|------------------------------|-------------------------------|
|                                                                                          | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses |
| Available-for-sale:                                                                      |                              |                               |                              |                               |
| Obligations of U.S. Government<br>agencies and corporations<br>Obligations of states and | \$2,865                      | \$466                         | \$2,142                      | \$827                         |
| political subdivisions                                                                   | 6,584                        | <u>130</u>                    | <u>5,264</u>                 | 2                             |
| Total available-for-sale                                                                 | <u>\$9,449</u>               | <u>\$596</u>                  | <u>\$7,406</u>               | <u>\$829</u>                  |

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

Available-for-sale

|                                               | Amortized cost | Fair<br>value |
|-----------------------------------------------|----------------|---------------|
| Due in one year or less                       | \$ 4,111       | \$ 4,188      |
| Due after one year through five years         | 11,074         | 11,633        |
| Due after five years through ten years        | 43,833         | 47,118        |
| Due after ten years                           | 170,000        | 174,932       |
| Other equity security having no maturity date | <u>350</u>     | 350           |
|                                               |                |               |

Securities with a carrying value of \$81,301,000 at December 31, 2012 and \$79,092,006 at December 31, 2011 were pledged to secure public deposits and for other purposes as required or permitted by law.

Restricted stock primarily consists of investments in Federal Home Loan Bank of Cincinnati and Federal Reserve Bank of Cleveland stock. The Bank's investment in Federal Home Loan Bank of Cincinnati stock amounted to \$2,551,000 at December 31, 2012 and 2011. The Bank's investment in Federal Reserve Bank of Cleveland stock amounted to \$1,448,000 at December 31, 2012 and \$1,118,000 in 2011.

Gross gains realized from sales of securities available-for-sale amounted to \$311,000 in 2012, \$149,000 in 2011, and \$11,000 in 2010 with the income tax provision applicable to such gains amounting to \$106,000 in 2012, \$51,000 in 2011, and \$4,000 in 2010. There were no securities sold at a loss in 2012, 2011, or 2010.

The following presents gross unrealized losses and fair value of securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2012 and 2011 (dollars in thousands):

### Securities in a continuous unrealized loss position

\$229,368

\$238,221

|                                                  | Less than<br>12 months |                 | 12 months<br>or more |                 | Total             |                 |
|--------------------------------------------------|------------------------|-----------------|----------------------|-----------------|-------------------|-----------------|
|                                                  | Unrealized losses      | Fair<br>value   | Unrealized losses    | Fair<br>value   | Unrealized losses | Fair<br>value   |
| 2012                                             |                        |                 |                      |                 |                   |                 |
| Obligations of U.S. Government agencies and      |                        |                 |                      |                 |                   |                 |
| corporations                                     | \$222                  | \$24,334        | \$244                | \$14,485        | \$466             | \$38,819        |
| Obligations of states and political subdivisions | 130                    | 6,299           |                      |                 | 130               | 6,299           |
| Total temporarily impaired securities            | <u>\$352</u>           | <u>\$30,633</u> | <u>\$244</u>         | <u>\$14,485</u> | <u>\$596</u>      | <u>\$45,118</u> |

#### **NOTE 5 – SECURITIES (CONTINUED)**

#### Securities in a continuous unrealized loss position

|                                             | Less than<br>12 months |                 | 12 months<br>or more |               | Total             |                 |  |
|---------------------------------------------|------------------------|-----------------|----------------------|---------------|-------------------|-----------------|--|
|                                             | Unrealized losses      | Fair<br>value   | Unrealized losses    | Fair<br>value | Unrealized losses | Fair<br>value   |  |
| 2011                                        |                        |                 |                      |               |                   |                 |  |
| Obligations of U.S. Government agencies and |                        |                 |                      |               |                   |                 |  |
| corporations                                | \$510                  | \$42,773        | \$317                | \$9,223       | \$827             | \$51,996        |  |
| Obligations of states and                   |                        |                 |                      |               |                   |                 |  |
| political subdivisions                      | 2                      | <u>515</u>      |                      |               | 2                 | <u>515</u>      |  |
| Total temporarily impaired                  |                        |                 |                      |               |                   |                 |  |
| securities                                  | <u>\$512</u>           | <u>\$43,288</u> | <u>\$317</u>         | \$9,223       | <u>\$829</u>      | <u>\$52,511</u> |  |

At December 31, 2012, there were 42 securities in an unrealized loss position, with 16 being in a continuous unrealized loss position for twelve months or more. When evaluating these securities for impairment, management considers the issuer's financial condition, whether the securities are issued by federally-sponsored government agencies or political subdivisions, whether downgrades by the bond rating agencies have occurred, industry analyst reports, and volatility in the bond market. Management has concluded that the unrealized losses as of December 31, 2012 were primarily the result of customary and expected fluctuations in the bond market related to changes in interest rates. As management has the ability and intent to hold debt securities until recovery and meets the more likely than not requirement regarding the ability to hold securities for a period of time sufficient to allow for any anticipated recovery in fair value for securities classified as available-for-sale, all security impairments as of December 31, 2012 are considered temporary.

During 2011, the repayment terms of a municipal bond in default were modified resulting in a decline in the estimated fair value of the bond that management considered to be other than temporary. As a result, the Bank recognized a permanent impairment of \$394,000 relating to the bond resulting in a charge to 2011 earnings. There were no further impairment adjustments with respect to the bond in 2012.

#### **NOTE 6 - LOANS**

Most of the Bank's lending activity is with clients primarily located within Erie County, Huron County, Ottawa County, Sandusky County, Seneca County, and Wood County. Credit concentrations, as determined using the North American Industry Classification System, that exceeded 5% of total loans at December 31, 2012 and 2011 include \$16,828,000 and \$14,589,000, respectively, to borrowers in the construction industry; \$25,067,000 and \$19,916,000, respectively, to borrowers in the accommodation and food service industry; \$21,362,000 and \$20,715,000, respectively, to borrowers in the manufacturing industry; and \$14,544,000 to borrowers in the agriculture industry in 2012.

The construction industry concentration includes loans to residential and commercial contractors who construct or install roads, sewers, bridges, homes, hotels, motels, apartment or commercial buildings, electrical and plumbing infrastructure, and air comfort systems. These loans are generally secured by real property, equipment, and receivables. Repayment is expected from cash flow from providing such services. The accommodation and food service industry concentration includes loans for the construction, purchase, and operation of hotels, restaurants, lounges, and campgrounds. These loans are generally secured by real property and equipment. Repayment is expected from cash flow from providing accommodations and food service to tourists, primarily visiting the Lake Erie region. The manufacturing industry concentration includes loans to local manufacturers who produce goods for a wide variety of industries, including chemical, automotive, and food processing. These loans are generally secured by real property, equipment, and receivables. Repayment is expected from cash flows generated from these operations. The agricultural industry concentration includes loans for farmland and lines of credit for equipment and grain production. These loans are generally secured by real property and equipment. Repayment is expected from cash flow from business activity generated from these operations.

Commercial and agricultural real estate loans are subject to underwriting standards and processes similar to commercial and agricultural operating loans, in addition to those unique to real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial and agricultural real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Loan-to-value is generally 75% of the cost or value of the assets. Appraisals on properties securing these loans are generally performed by appraisers approved by the Board of Directors. Because payments on commercial and agricultural real estate loans may be subject to adverse conditions in the real estate market or the economy. Management monitors and evaluates commercial and agricultural real estate loans based on collateral and risk rating criteria. The Corporation generally requires guarantees on these loans. The Corporation's commercial and agricultural real estate loans are secured primarily by properties located in its market area.

Commercial and agricultural operating loans are underwritten based on the Corporation's examination of current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. This underwriting standard includes the evaluation of cash flows of the borrower, underlying collateral, if applicable, and the borrower's ability to manage its business activities. The cash flows of borrowers and the collateral securing these loans may fluctuate in value after the initial evaluation. A first priority lien on the general assets of the business normally secures these types of loans. Loan-to-value limits vary and are dependent upon the nature and type of the underlying collateral and the financial strength of the borrower. Crop and hail insurance is recommended for most agricultural borrowers. Loans are generally guaranteed by the principal owner. The Corporation makes commercial and agricultural operating loans primarily in its market area.

Construction loans are underwritten utilizing independent appraisals, sensitivity analysis of absorption, vacancy and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and values associated with the completed project, and are subjective by nature. These loans are closely monitored by on-site inspections. The Corporation's construction loans are secured primarily by properties located in its market area.

The Corporation originates 1-4 family real estate and consumer loans utilizing credit reports to supplement the underwriting process. The Corporation's underwriting standards for 1-4 family loans are generally in accordance with FHLMC and FNMA underwriting guidelines. Properties securing 1-4 family real estate loans are appraised by appraisers who are independent of the loan origination function and have been approved by the Board of Directors. The loan-to-value ratios normally do not exceed 80% without credit enhancements such as mortgage insurance. The Corporation will lend up to 100% of the lesser of the appraised value or purchase price for conventional 1-4 family real estate loans, provided private mortgage insurance is obtained. The underwriting standards for consumer loans include a determination of the applicant's payment history on other debts and an assessment of their ability to meet existing obligations and payments on the proposed loan. To monitor and manage loan risk, policies and procedures are developed, and modified as needed by management. This activity, coupled with smaller loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, market conditions are reviewed by management on a regular basis. The Corporation's 1-4 family real estate loans are secured primarily by properties located in its market area.

The Corporation maintains an internal credit analysis department that reviews and validates the credit risk program on a periodic basis, as well as an external loan review performed annually or semi-annually. Results of these reviews are presented to management and the Audit Committee of the Board of Directors. The credit analysis and loan review processes compliment and reinforce the risk identification and assessment decisions made by lenders and credit personnel, as well as the Corporation's policies and procedures.

Credit losses arising from the Bank's lending experience in these industries compare favorably with the Bank's loss experience on its loan portfolio as a whole. Credit evaluation of construction industry and accommodation and food service industry lending is based on an evaluation of cash flow coverage of principal and interest payments and the adequacy of collateral received.

The following presents the balances in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2012 and 2011 (dollars in thousands):

|                                                                                                                                                        |                    |                      | Real Estate         |                   |                 |                 |                   |
|--------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------|----------------------|---------------------|-------------------|-----------------|-----------------|-------------------|
|                                                                                                                                                        | Commercial         | Residential          | Non-<br>residential | Construction      | Consumer        | Credit card     | Total             |
| <u>2012</u>                                                                                                                                            | Commoroidi         | riooraoritiar        | roordonnar          | Conociación       | Concumor        | ouru            | i Otai            |
| Allowance for loan losses: Ending allowance balance attributable to loans: Individually evaluated for                                                  |                    |                      |                     |                   |                 |                 |                   |
| impairment<br>Collectively<br>evaluated for                                                                                                            |                    | \$ 283               | \$ 247              | \$ -              | \$ -            | \$ -            | \$ 536            |
| impairment                                                                                                                                             | <u>615</u>         | <u>1,665</u>         | 1,120               | <u>184</u>        | 127             | <u>78</u>       | 3,789             |
| Total                                                                                                                                                  | <u>\$ 621</u>      | <u>\$ 1,948</u>      | <u>\$ 1,367</u>     | <u>\$ 184</u>     | <u>\$ 127</u>   | <u>\$ 78</u>    | <u>\$ 4,325</u>   |
| Loans:  Loans individually  evaluated for  impairment  Loans collectively                                                                              | \$ 909             | \$ 2,642             | \$ 3,606            | \$ -              | \$ -            | \$ -            | \$ 7,157          |
| evaluated for<br>impairment                                                                                                                            | 34,394             | 125,610              | 132,331             | 3,635             | 15,234          | 2,916           | 314,120           |
| Total                                                                                                                                                  | <u>\$35,303</u>    | <u>\$128,252</u>     | <u>\$135,937</u>    | <u>\$ 3,635</u>   | <u>\$15,234</u> | <u>\$ 2,916</u> | <u>\$321,277</u>  |
| <u>2011</u>                                                                                                                                            |                    |                      |                     |                   |                 |                 |                   |
| Allowance for loan losses: Ending allowance balance attributable to loans: Individually evaluated for impairment Collectively evaluated for impairment | \$ -               | \$ 496<br>1,409      | \$ 646<br>1,280     | \$ 53<br>126      | \$ -<br>84      | \$ -            | \$ 1,195<br>3,583 |
|                                                                                                                                                        |                    |                      |                     |                   |                 |                 |                   |
| Total                                                                                                                                                  | <u>\$ 615</u>      | <u>\$ 1,905</u>      | <u>\$ 1,926</u>     | <u>\$ 179</u>     | <u>\$ 84</u>    | <u>\$ 69</u>    | <u>\$ 4,778</u>   |
| Loans:  Loans individually  evaluated for  impairment  Loans collectively  evaluated for  impairment                                                   | \$ 685<br>_ 28,278 | \$ 2,912<br>_124,538 | \$ 11,220<br>       | \$ 1,059<br>4,178 | \$ -<br>        | \$ -<br>2,697   | \$ 15,876<br>     |
| Total                                                                                                                                                  | <u>\$ 28,963</u>   | <u>\$127,450</u>     | <u>\$126,415</u>    | <u>\$ 5,237</u>   | <u>\$11,203</u> | <u>\$ 2,697</u> | <u>\$301,965</u>  |
|                                                                                                                                                        |                    |                      |                     |                   | <del></del>     |                 |                   |

Fixed-rate loans amounted to \$137,001,000 at December 31, 2012 and \$109,344,000 at December 31, 2011.

The following represents loans individually evaluated for impairment by class of loans as of December 31, 2012 and 2011 (dollars in thousands):

| ,                                           | 2012                           |                     |                             | 2011                           |                     |                             |  |
|---------------------------------------------|--------------------------------|---------------------|-----------------------------|--------------------------------|---------------------|-----------------------------|--|
|                                             |                                |                     | Allowance<br>for            |                                |                     | Allowance<br>for            |  |
|                                             | Unpaid<br>principal<br>balance | Recorded investment | loan<br>losses<br>allocated | Unpaid<br>principal<br>balance | Recorded investment | loan<br>losses<br>allocated |  |
| With no related allowance recorde           | ed:                            |                     |                             |                                |                     |                             |  |
| Commercial loans                            | \$ 771                         | \$ 771              | \$ -                        | \$ 630                         | \$ 630              | \$ -                        |  |
| Commercial overdraft LOC                    | 61                             | 61                  | -                           | 55                             | 55                  | -                           |  |
| Open-end home equity                        | 177                            | 177                 | -                           | 19                             | 19                  | -                           |  |
| 1 – 4 family real estate                    |                                |                     |                             |                                |                     |                             |  |
| (1st mortgages)                             | 1,110                          | 1,103               | -                           | 873                            | 863                 | -                           |  |
| 1 – 4 family real estate                    |                                |                     |                             |                                |                     |                             |  |
| (Jr. mortgages)                             | 14                             | 14                  | -                           | 77                             | 77                  | -                           |  |
| Multifamily real estate                     | 200                            | 200                 | -                           | -                              | -                   | -                           |  |
| Non-farm/non-residential                    |                                |                     |                             |                                |                     |                             |  |
| real estate                                 | 788                            | 638                 | -                           | 8,246                          | 8,246               | -                           |  |
| With an allowance recorded:                 | 70                             | 70                  |                             |                                |                     |                             |  |
| Commercial loans                            | 76                             | 76                  | 6                           | -                              | -                   | -                           |  |
| 1 – 4 family real estate                    | 4 007                          | 4.400               | 007                         | 0.007                          | 4 040               | 400                         |  |
| (1st mortgages)                             | 1,297                          | 1,133               | 267                         | 2,097                          | 1,818               | 433                         |  |
| 1 – 4 family real estate                    | 16                             | 16                  | 16                          | 105                            | 105                 | 60                          |  |
| (Jr. mortgages)<br>Non-farm/non-residential | 16                             | 10                  | 10                          | 135                            | 135                 | 63                          |  |
| real estate                                 | 2,968                          | 2,968               | 247                         | 3,395                          | 2,974               | 646                         |  |
| Construction real estate                    | 2,900                          | 2,900               | <b>24</b> 1                 | 1,059                          | 1,059               | <u>53</u>                   |  |
| Constituction real estate                   | <del></del>                    |                     |                             | 1,008                          | 1,039               |                             |  |
| Total                                       | <u>\$7,478</u>                 | <u>\$7,157</u>      | <u>\$536</u>                | <u>\$16,586</u>                | <u>\$15,876</u>     | <u>\$1,195</u>              |  |

The following is additional information with respect to impaired loans for the years ended December 31, 2012, 2011, and 2010 (dollars in thousands):

| ,                                                            | 2012            | 2011            | 2010           |
|--------------------------------------------------------------|-----------------|-----------------|----------------|
| Average investment in impaired loans                         | <u>\$ 7,448</u> | <u>\$ 9,425</u> | <u>\$6,392</u> |
| Interest income recognized on impaired loans                 | <u>\$ 306</u>   | <u>\$ 281</u>   | <u>\$ 345</u>  |
| Interest income recognized on a cash basis on impaired loans | <u>\$ 39</u>    | <u>\$ 33</u>    | <u>\$ 36</u>   |

No additional funds are committed to be advanced in connection with impaired loans.

The following represents the recorded investment and number of troubled debt restructurings (TDRs) by class of loan as of December 31, 2012 and 2011:

|                                         | 2         | 012             | 2011      |          |  |
|-----------------------------------------|-----------|-----------------|-----------|----------|--|
|                                         | Number    | Amount          | Number    | Amount   |  |
| Commercial loans                        | 3         | \$ 848          | 1         | \$ 54    |  |
| Open-end home equity                    | 3         | 150             | -         | -        |  |
| 1 – 4 family real estate (1st mortgage) | 12        | 1,038           | 7         | 413      |  |
| 1 – 4 family real estate (Jr. mortgage) | 2         | 14              | 1         | 99       |  |
| Non-farm/non-residential real estate    | 9         | 3,208           | 8         | 3,569    |  |
| Construction real estate                |           |                 | 1         | 692      |  |
| Total troubled debt restructurings      | <u>29</u> | <u>\$ 5,258</u> | <u>18</u> | \$ 4,827 |  |

The following represents a summary of the number and recorded investments of TDRs occurring during the years ended December 31, 2012 and 2011:

| •                                       | 2         | 012             | 2011     |               |  |
|-----------------------------------------|-----------|-----------------|----------|---------------|--|
|                                         | Number    | Amount          | Number   | Amount        |  |
| Commercial loans                        | 2         | \$ 771          | 1        | \$ 54         |  |
| Open-end home equity                    | 2         | 134             | -        | -             |  |
| 1 – 4 family real estate (1st mortgage) | 6         | 579             | 3        | 184           |  |
| 1 – 4 family real estate (Jr. mortgage) | 2         | 15              | -        | -             |  |
| Non-farm/non-residential real estate    | _2        | <u>149</u>      | <u>4</u> | 607           |  |
| Total recorded investments              | <u>14</u> | <u>\$ 1,648</u> | <u>8</u> | <u>\$ 845</u> |  |

The provision for loan losses relating to loans that were modified in troubled debt restructurings amounted to \$33,000 in 2012 and \$305,000 in 2011.

The following is a summary of the conditions and modifications for TDRs occurring during 2012:

- Two of the modifications resulted in extending the maturity and a new amortization schedule.
- Two modifications resulted in a reduced interest rate.
- Two modifications had an independent source bring the loans current and agree to service the loans for a specified period of time.
- Two modifications had a reduction of principal and interest resulting in a balloon payment at maturity.
- One modification resulted in principal and interest being suspended for 11 months.
- Two modifications resulted in interest only concessions for six and four month periods, respectively.
- Two modifications resulted in reduced principal and interest payments for six and 12 months periods, respectively.
- One modification resulted in the renewal of a line-of-credit in exchange for loan term changing from interest only to principal and interest during the renewal period.

For TDRs occurring during 2011, four of the loan modifications resulted in principal reductions. Three of the non-farm/non-residential real estate loans, to the same borrower, had a restructured rate. The other non-farm/non-residential real estate loan was placed in OREO.

The post-modification balances approximate the pre-modification balances. The aggregate amount of charge-offs as a result of a restructuring are not significant.

There were no subsequent defaults on troubled debt restructurings during the year ended December 31, 2012.

The Bank does not have material commitments to lend additional funds to borrowers with loans whose terms have been modified in troubled debt restructuring or whose loans are on nonaccrual.

The following presents the recorded investment in past due and non-accrual loans as of December 31, 2012 and 2011 by class of loans (dollars in thousands).

|                                                       | асо<br>30 – 89  | Past due<br>cruing inte<br>90+ |                 | Non-            | Not<br>past due<br>or non- |                  |
|-------------------------------------------------------|-----------------|--------------------------------|-----------------|-----------------|----------------------------|------------------|
| 2012                                                  | days            | days                           | Total           | accrual         | accrual                    | Total            |
| Agricultural loans                                    | \$ -            | \$ -                           | \$ -            | \$ -            | \$ 5,283                   | \$ 5,283         |
| Commercial loans                                      | φ -<br>17       | φ -                            | φ -<br>17       | φ -             | 28,962                     | 28,979           |
| Commercial overdraft LOC                              | -               | _                              | -               | _               | 306                        | 306              |
| Commercial non-profit/political                       |                 |                                |                 |                 | 300                        | 555              |
| subdivisions                                          | -               | -                              | -               | -               | 733                        | 733              |
| Open-end home equity                                  | 234             | 154                            | 388             | 26              | 25,528                     | 25,942           |
| 1 – 4 family real estate                              |                 |                                |                 |                 |                            |                  |
| (1st mortgages)                                       | 1,885           | 770                            | 2,655           | 1,595           | 89,838                     | 94,088           |
| 1 – 4 family real estate                              |                 |                                |                 |                 |                            |                  |
| (Jr. mortgages)                                       | 141             | 38                             | 179             | 16              | 7,828                      | 8,023            |
| Multifamily real estate                               | -               | -                              | -               | 200             | 10,030                     | 10,230           |
| Farm real estate                                      | -               | -                              | -               | -               | 9,554                      | 9,554            |
| Non-farm/non-residential real estate                  | 389             | -                              | 389             | 916<br>-        | 115,049<br>3,635           | 116,354          |
| Construction real estate Consumer loans – vehicle     | 37              | -                              | -<br>37         | -               | 5,035<br>5,227             | 3,635<br>5,264   |
| Consumer overdraft LOC                                | 4               | -<br>1                         | 5               | -               | 5,227<br>449               | 5,204<br>454     |
| Consumer loans:                                       | 4               |                                | 3               | _               | 443                        | 454              |
| Mobile home                                           | _               | _                              | _               | _               | 561                        | 561              |
| Home Improvement                                      | _               | _                              | _               | _               | 220                        | 220              |
| Other                                                 | 95              | -                              | 95              | -               | 8,640                      | 8,735            |
| MasterCard/VISA                                       | 33              | 4                              | 37              |                 | 2,879                      | 2,916            |
| Tatal                                                 |                 | Φ.007                          | Ф 0 000         | Φ 0 750         |                            |                  |
| Total                                                 | <u>\$ 2,835</u> | <u>\$ 967</u>                  | <u>\$ 3,802</u> | <u>\$ 2,753</u> | <u>\$314,722</u>           | <u>\$321,277</u> |
| <u>2011</u>                                           |                 |                                |                 |                 |                            |                  |
| Agricultural loans                                    | \$ -            | \$ -                           | \$ -            | \$ -            | \$ 3,207                   | \$ 3,207         |
| Commercial loans                                      | 16              | -                              | 16              | 88              | 24,324                     | 24,428           |
| Commercial overdraft LOC                              | -               | -                              | -               | -               | 408                        | 408              |
| Commercial non-profit/political                       |                 |                                |                 |                 |                            |                  |
| subdivisions                                          | -               | -                              | -               | -               | 920                        | 920              |
| Open-end home equity                                  | 213             | 91                             | 304             | 19              | 27,293                     | 27,616           |
| 1 – 4 family real estate                              |                 |                                |                 |                 |                            |                  |
| (1st mortgages)                                       | 2,046           | 566                            | 2,612           | 2,338           | 84,957                     | 89,907           |
| 1 – 4 family real estate                              | 40              | •                              |                 | 440             | 0.757                      | 0.007            |
| (Jr. mortgages)                                       | 48              | 9                              | 57              | 113             | 9,757                      | 9,927            |
| Multifamily real estate                               | -               | -                              | -               | -               | 8,829                      | 8,829            |
| Farm real estate Non-farm/non-residential real estate | 38<br>616       | -                              | 38<br>616       | -<br>1,054      | 8,655                      | 8,693<br>108,893 |
| Construction real estate                              | -               |                                | -               | 1,054           | 107,223<br>4,178           | 5,237            |
| Consumer loans – vehicle                              | 6               | -                              | 6               | 1,059           | 3,410                      | 3,416            |
| Consumer overdraft LOC                                | 9               | _                              | 9               | _               | 227                        | 236              |
| Consumer loans:                                       | Ü               |                                | Ü               |                 |                            | 200              |
| Mobile home                                           | 18              | _                              | 18              | _               | 706                        | 724              |
| Home Improvement                                      | -               | -                              | -               | -               | 194                        | 194              |
| Other                                                 | 41              | -                              | 41              | -               | 6,592                      | 6,633            |
| MasterCard/VISA                                       | 30              | 6                              | <u>36</u>       |                 | 2,661                      | 2,697            |
| Total                                                 | \$ 3,081        | <u>\$ 672</u>                  | <u>\$ 3,753</u> | <u>\$ 4,671</u> | <u>\$293,541</u>           | <u>\$301,965</u> |

The Bank categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Bank uses the following definitions for risk ratings:

- **Special Mention** Loans classified special mention, possess some credit deficiency or potential weakness that deserves close attention, but do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk of losses in the future.
- Substandard Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard have well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are categorized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- **Doubtful** Loans classified as doubtful have all of the weaknesses of those classified as substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. The following presents loans as of December 31, 2012 and 2011 that are collectively evaluated for impairment and are not considered to be impaired (dollars in thousands):

|                                              |                  | Special          | Sub-            |             | Not             |                  |
|----------------------------------------------|------------------|------------------|-----------------|-------------|-----------------|------------------|
| <u>2012</u>                                  | Pass             | mention          | standard        | Doubtful    | rated           | Total            |
| Agricultural loans                           | \$ 5,283         | \$ -             | \$ -            | \$ -        | \$ -            | \$ 5,283         |
| Commercial loans                             | 25,213           | 2,778            | 142             | -           | -               | 28,133           |
| Commercial overdraft LOC                     | -                | -                | -               | -           | 245             | 245              |
| Commercial non-profit/political subdivisions | 733              | -                | -               | -           | -               | 733              |
| Open-end home equity                         | 25,142           | 351              | 272             | -           | -               | 25,765           |
| 1 – 4 family real estate (1st mortgages)     | 88,183           | 1,635            | 2,034           | -           | -               | 91,852           |
| 1 – 4 family real estate (Jr. mortgages)     | 7,662            | 54               | 277             | -           | -               | 7,993            |
| Multifamily real estate                      | 7,599            | -                | 2,431           | -           | -               | 10,030           |
| Farm real estate                             | 9,509            | 45               | -               | -           | -               | 9,554            |
| Non-farm/non-residential real estate         | 96,184           | 14,344           | 2,219           | -           | -               | 112,747          |
| Construction real estate                     | 3,007            | 628              | -               | -           | -               | 3,635            |
| Consumer loans – vehicle                     | 5,249            | 10               | 5               | -           | -               | 5,264            |
| Consumer overdraft LOC                       | -                | -                | -               | -           | 454             | 454              |
| Consumer loans:                              |                  |                  |                 |             |                 |                  |
| Mobile home                                  | 561              |                  | -               | -           | -               | 561              |
| Home improvement                             | 220              | -                | -               | -           | -               | 220              |
| Other                                        | 8,722            | 8                | 5               | -           | -               | 8,735            |
| MasterCard/VISA                              | <u> </u>         |                  |                 |             | 2,916           | 2,916            |
| Total                                        | \$283,267        | <u>\$ 19,853</u> | <u>\$ 7,385</u> | <u>\$ -</u> | <u>\$ 3,615</u> | <u>\$314,120</u> |
| <u>2011</u>                                  |                  |                  |                 |             |                 |                  |
| Agricultural loans                           | \$ 3,207         | \$ -             | \$ -            | \$ -        | \$ -            | \$ 3,207         |
| Commercial loans                             | 23,596           | 192              | 10              | Ψ <u>-</u>  | · -             | 23,798           |
| Commercial overdraft LOC                     | -                | -                | -               | _           | 353             | 353              |
| Commercial non-profit/political subdivisions | 920              | _                | _               | _           | -               | 920              |
| Open-end home equity                         | 26,879           | 449              | 268             | _           | _               | 27,596           |
| 1 – 4 family real estate (1st mortgages)     | 83,743           | 1,233            | 2,250           | _           | _               | 87,226           |
| 1 – 4 family real estate (Jr. mortgages)     | 9,416            | -                | 300             | _           | _               | 9,716            |
| Multifamily real estate                      | 5,973            | _                | 2,856           | _           | _               | 8,829            |
| Farm real estate                             | 8,645            | 47               | -,555           | _           | _               | 8,692            |
| Non-farm/non-residential real estate         | 80,391           | 12,279           | 5,004           | _           | _               | 97,674           |
| Construction real estate                     | 3,220            | -                | 958             | _           | _               | 4,178            |
| Consumer loans – vehicle                     | 3,408            | 3                | 5               | _           | _               | 3,416            |
| Consumer overdraft LOC                       | -                | -                | -               | _           | 236             | 236              |
| Consumer loans:                              |                  |                  |                 |             |                 |                  |
| Mobile home                                  | 706              | 18               | _               | _           | _               | 724              |
| Home improvement                             | 194              | -                | _               | _           | _               | 194              |
| Other                                        | 6,577            | 36               | 20              | _           | _               | 6,633            |
| MasterCard/VISA                              |                  |                  |                 |             | 2,697           | <u>2,697</u>     |
| Total                                        | <u>\$256,875</u> | \$ 14,257        | <u>\$11,671</u> | <u>\$ -</u> | \$ 3,286        | \$286,089        |
|                                              | 0                | 7                |                 |             |                 |                  |

Certain directors and executive officers, including their immediate families and companies in which they are principal owners, are loan clients of the Bank. Such loans are made in the ordinary course of business in accordance with the Bank's normal lending policies, including the interest rate charged and collateralization, and do not represent more than a normal collection risk. Such loans amounted to \$739,000 and \$860,000 at December 31, 2012 and 2011, respectively.

The following is a summary of activity during 2012, 2011, and 2010, with loan renewals included in additions and repayments (dollars in thousands):

|      | Balance at beginning | Additions     | Repayments    | Balance at end |
|------|----------------------|---------------|---------------|----------------|
| 2012 | <u>\$ 860</u>        | <u>\$ 229</u> | <u>\$ 350</u> | <u>\$ 739</u>  |
| 2011 | <u>\$ 756</u>        | <u>\$ 398</u> | <u>\$ 294</u> | <u>\$ 860</u>  |
| 2010 | <u>\$1,108</u>       | <u>\$ 350</u> | <u>\$ 702</u> | <u>\$ 756</u>  |

#### **NOTE 7 - ALLOWANCE FOR LOAN LOSSES**

The following represents a summary of activity in the allowance for loan losses for the years ended December 31, 2012, 2011, and 2010 (dollars in thousands):

|                                 | 2012           | 2011           | 2010           |
|---------------------------------|----------------|----------------|----------------|
| Balance at beginning of year    | \$4,778        | \$4,955        | \$4,433        |
| Provision charged to operations | 525            | 775            | 1,675          |
| Loans charged-off               | (1,084)        | (1,786)        | (1,309)        |
| Recoveries of loans charged-off | 106            | 834            | <u>156</u>     |
| Balance at end of year          | <u>\$4,325</u> | <u>\$4,778</u> | <u>\$4,955</u> |

The following presents the balances and activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2012 and 2011 (dollars in thousands):

|                                                             | Commercial   | Residential<br>real<br>estate | Non-<br>residential<br>real<br>estate | Construction<br>real<br>estate | Consumer     | Credit card | Total          |
|-------------------------------------------------------------|--------------|-------------------------------|---------------------------------------|--------------------------------|--------------|-------------|----------------|
| Balance at December 31, 2011<br>Provision (credit) for loan | \$615        | \$1,905                       | \$1,926                               | \$179                          | \$ 84        | \$69        | \$4,778        |
| losses                                                      | (7)          | 628                           | (232)                                 | 5                              | 105          | 26          | 525            |
| Loans charged off                                           | (2)          | (602)                         | (382)                                 | -                              | (75)         | (23)        | (1,084)        |
| Recoveries                                                  | <u>15</u>    | <u>17</u>                     | <u>55</u>                             |                                | <u>13</u>    | <u>6</u>    | <u>106</u>     |
| Balance at December 31, 2012                                | <u>\$621</u> | <u>\$1,948</u>                | <u>\$1,367</u>                        | <u>\$184</u>                   | <u>\$127</u> | <u>\$78</u> | <u>\$4,325</u> |
| Balance at December 31, 2010<br>Provision (credit) for loan | \$542        | \$1,857                       | \$2,049                               | \$347                          | \$ 85        | \$75        | \$ 4,955       |
| losses                                                      | (74)         | 720                           | 256                                   | (168)                          | 14           | 27          | 775            |
| Loans charged off                                           | (56)         | (746)                         | (903)                                 | -                              | (38)         | (43)        | (1,786)        |
| Recoveries                                                  | 203          | 74                            | <u>524</u>                            |                                | <u>23</u>    | <u>10</u>   | <u>834</u>     |
| Balance at December 31, 2011                                | <u>\$615</u> | <u>\$1,905</u>                | <u>\$1,926</u>                        | <u>\$179</u>                   | <u>\$ 84</u> | <u>\$69</u> | <u>\$4,778</u> |

#### **NOTE 8 - PREMISES AND EQUIPMENT**

The following is a summary of premises and equipment at December 31, 2012 and 2011 (dollars in thousands):

|                                           | 2012                               | 2011                               |
|-------------------------------------------|------------------------------------|------------------------------------|
| Land and improvements Buildings Equipment | \$ 1,884<br>11,655<br><u>7,069</u> | \$ 1,934<br>11,775<br><u>6,843</u> |
| Less accumulated depreciation             | 20,608<br>13,094                   | 20,552<br>12,337                   |
| Premises and equipment, net               | <u>\$ 7,514</u>                    | <u>\$ 8,215</u>                    |

Depreciation of premises and equipment amounted to \$757,000 in 2012, \$743,000 in 2011, and \$764,000 in 2010.

#### **NOTE 9 - SECONDARY MARKET LENDING**

As part of its normal business activity, the Bank services loans for others, including substantially all qualifying fixed-rate residential mortgage loans which it originates and sells in the secondary market with servicing retained. Serviced loans are not reported as assets of the Bank and amounted to \$26,496,000 and \$24,001,000 as of December 31, 2012 and 2011, respectively.

Loans sold in the secondary market amounted to \$8,052,000 in 2012, \$4,521,000 in 2011, and \$10,813,000 in 2010. Such sales resulted in gain on sales of loans of \$246,000 in 2012, \$115,000 in 2011, and \$282,000 in 2010, including gains resulting from capitalized servicing rights of \$65,000 in 2012, \$39,000 in 2011, and \$109,000 in 2010. Amortization of mortgage servicing rights amounted to \$62,000 in 2012, \$59,000 in 2011, and \$73,000 in 2010. Mortgage servicing rights are included in other assets in the accompanying consolidated balance sheets and amounted to \$144,000 and \$141,000 at December 31, 2012 and 2011, respectively.

#### **NOTE 10 - DEPOSITS**

Time deposits at December 31, 2012 and 2011 included individual deposits of \$100,000 and over amounting to \$43,222,000 and \$53,787,000, respectively. Interest expense on time deposits of \$100,000 or more amounted to \$532,000 in 2012, \$601,000 in 2011, and \$887,000 in 2010.

At December 31, 2012, the scheduled maturities of time deposits were as follows (dollars in thousands):

| 2013       | \$ 67,850        |
|------------|------------------|
| 2014       | 22,438           |
| 2015       | 29,915           |
| 2016       | 27,497           |
| 2017       | 5,776            |
| Thereafter | <u>7,074</u>     |
| Total      | <u>\$160,550</u> |

#### **NOTE 11 - BORROWED FUNDS**

Borrowed funds consist of the following at December 31, 2012 and 2011 (dollars in thousands):

|                                                                                      | 2012            | 2011            |
|--------------------------------------------------------------------------------------|-----------------|-----------------|
| Federal Home Loan Bank (FHLB):                                                       |                 |                 |
| Secured note, with interest at 4.86%, due December 2012                              | \$ -            | \$ 2,500        |
| Secured note, with interest at 2.74%, due December 2013                              | 5,000           | 5,000           |
| Secured note, with interest at 4.45%, due February 2017                              | <u>5,000</u>    | 5,000           |
| Great Lakes Bankers Bank (GLBB):                                                     | 10,000          | 12,500          |
| Term note payable in quarterly installments of \$337,000 including                   |                 |                 |
| interest at the greater of prime rate or 4.5% with any remaining                     |                 |                 |
| principal due January 1, 2017. Loan is secured by certain assets                     |                 |                 |
| of the Corporation as stated in the pledge agreement dated                           |                 |                 |
| October 20, 2011.                                                                    | <u>5,199</u>    | 6,000           |
| Total                                                                                | <u>\$15,199</u> | <u>\$18,500</u> |
| Future maturities of borrowed funds at December 31, 2012 were as follows (dollars in | thousands):     |                 |
| 2013                                                                                 |                 | \$ 6,129        |
| 2014                                                                                 |                 | 1,181           |
| 2015                                                                                 |                 | 1,236           |
| 2016                                                                                 |                 | 1,293           |
| 2017                                                                                 |                 | <u>5,360</u>    |
| Total                                                                                |                 | <u>\$15,199</u> |

The FHLB notes require monthly interest payments and are secured by stock in the FHLB of Cincinnati and eligible mortgage loans totaling \$273,058,000 at December 31, 2012.

The GLBB term note contains certain financial covenants which require the Corporation and Bank to, among other things, maintain minimum return on equity, return on assets, and debt service coverage ratios (as defined), as well as asset quality and liquidity levels.

At December 31, 2012, the Bank had available borrowings of \$70,417,000 under its line of credit with the FHLB. In addition, the Bank had \$17,000,000 of short-term borrowing availability at December 31, 2012, under lines of credit with two correspondent banks.

#### **NOTE 12 - SECURITIES SOLD UNDER REPURCHASE AGREEMENTS**

Securities sold under repurchase agreements, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under repurchase agreements are reflected at the amount of cash received in connection with the transactions. The Bank may be required to provide additional collateral based on the fair value of the underlying securities.

#### **NOTE 13 - NON-INTEREST EXPENSES**

The following is a summary of non-interest expenses for the years ended December 31, 2012, 2011, and 2010 (dollars in thousands):

| ,                                              | 2012            | 2011            | 2010            |
|------------------------------------------------|-----------------|-----------------|-----------------|
| Salaries, wages, and employee benefits         | \$ 8,922        | \$ 8,384        | \$ 8,271        |
| Occupancy of premises                          | 961             | 851             | 838             |
| Amortization of core deposit intangible assets | 400             | 58              | 58              |
| FDIC premium assessments                       | 392             | 372             | 528             |
| Equipment and vehicle                          | 1,242           | 1,096           | 1,067           |
| Professional and examination                   | 766             | 838             | 687             |
| State franchise and other taxes                | 643             | 512             | 516             |
| Postage, stationery, and supplies              | 530             | 483             | 481             |
| Advertising and marketing                      | 292             | 217             | 190             |
| Third-party computer processing                | 210             | 223             | 278             |
| MasterCard franchise and processing            | 168             | 125             | 134             |
| Loan collection and repossession fees          | 381             | 359             | 291             |
| ATM network and processing fees                | 357             | 151             | 174             |
| Other                                          | <u>1,153</u>    | <u>1,339</u>    | <u>1,219</u>    |
| Total non-interest expenses                    | <u>\$16,417</u> | <u>\$15,008</u> | <u>\$14,732</u> |

#### **NOTE 14 - FEDERAL INCOME TAXES**

The provision for federal income taxes consisted of the following for 2012, 2011, and 2010 (dollars in thousands):

|                     | 2012                | 2011                    | 2010                     |
|---------------------|---------------------|-------------------------|--------------------------|
| Current<br>Deferred | \$535<br><u>206</u> | \$1,253<br><u>(55</u> ) | \$1,306<br><u>(303</u> ) |
| Total               | \$741               | \$1,198                 | \$1,003                  |

The income tax provision attributable to income from operations differs from the amounts computed by applying the U.S. federal income tax rate of 34% to income before federal income taxes as a result of the following (dollars in thousands):

|                                                                                                                                                                                    | 2012          | 2011           | 2010           |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|----------------|----------------|
| Expected tax using statutory tax rate of 34% Increase (decrease) in tax resulting from:                                                                                            | \$1,899       | \$2,023        | \$1,709        |
| Tax-exempt income on state and municipal securities and political subdivision loans Interest expense associated with carrying certain state and municipal securities and political | (1,033)       | (781)          | (595)          |
| subdivision loans                                                                                                                                                                  | 30            | 32             | 35             |
| Increase in cash value of life insurance policies                                                                                                                                  | (109)         | (102)          | (131)          |
| Other, net                                                                                                                                                                         | <u>(46</u> )  | <u>26</u>      | <u>(15</u> )   |
| Total                                                                                                                                                                              | <u>\$ 741</u> | <u>\$1,198</u> | <u>\$1,003</u> |

The deferred federal income tax provision (credit) of \$206,000 in 2012, (\$55,000) in 2011, and (\$303,000) in 2010, resulted from the tax effects of temporary differences. There was no impact for changes in tax laws and rates or changes in the valuation allowance for deferred tax assets.

#### NOTE 14 - FEDERAL INCOME TAXES (CONTINUED)

The tax effects of temporary differences that give rise to significant portions of deferred tax liabilities and deferred tax assets at December 31, 2012 and 2011 are presented below (dollars in thousands):

|                                                  | 2012            | 2011            |
|--------------------------------------------------|-----------------|-----------------|
| Deferred tax liabilities:                        |                 |                 |
| Unrealized gain on securities available-for-sale | \$ 3,010        | \$ 2,236        |
| Purchase accounting basis difference             | 370             | 149             |
| Depreciation of premises and equipment           | 204             | 148             |
| Federal Home Loan Bank stock dividends           | 455             | 455             |
| Direct financing leases                          | 63              | 102             |
| Deferred loan costs and other                    | <u>115</u>      | <u>145</u>      |
| Total deferred tax liabilities                   | 4,217           | 3,235           |
| Deferred tax assets:                             |                 |                 |
| Allowance for loan losses                        | 1,176           | 1,246           |
| Accrued expenses and other                       | 564             | 501             |
| Alternative minimum tax credit carryforward      | 9               |                 |
| Total deferred tax assets                        | <u>1,749</u>    | 1,747           |
| Net deferred tax liabilities                     | <u>\$ 2,468</u> | <u>\$ 1,488</u> |

Net deferred tax liabilities at December 31, 2012 and 2011 are included in other liabilities in the accompanying consolidated balance sheets.

The alternative minimum tax credit carryforward of \$9,000 at December 31, 2012 may be utilized in the future to the extent computed regular tax exceeds the alternative minimum tax.

Management believes it is more likely than not that the benefit of deferred tax assets will be realized. Consequently, no valuation allowance for deferred tax assets is deemed necessary as of December 31, 2012 and 2011.

In management's determination, the Corporation has no tax positions for which it deems reasonably possible that the total amounts of the unrecognized tax benefit will significantly increase or decrease within the 12 months subsequent to December 31, 2012. The tax years that remain open and subject to examination as of December 31, 2012 are years 2009 – 2012 for Federal and the State of Ohio.

#### **NOTE 15 - EMPLOYEE BENEFITS**

The Bank sponsors The Croghan Colonial Bank 401(k) Profit Sharing Plan, a defined contribution plan which provides for both profit sharing and employer matching contributions. The Plan permits the investing in the Corporation's stock subject to various limitations. The Bank's profit sharing and matching contributions to the 401(k) profit sharing plan for the years ended December 31, 2012, 2011, and 2010 amounted to \$372,000, \$372,000, and \$345,000, respectively. As of December 31, 2012, the Plan held 27,850 shares of the Corporation's common stock.

The Bank has entered into various split-dollar life insurance arrangements, including agreements with certain officers and employees of the Bank to provide for supplemental retirement benefits. All split-dollar policies required the payment of single premiums. The cash value of all split-dollar policies amounted to \$11,087,000 and \$10,766,000 at December 31, 2012 and 2011, respectively.

In connection with the agreements, the Bank provided an estimated liability for accumulated supplemental retirement benefits of \$210,000 at December 31, 2012 and \$199,000 at December 31, 2011, which is included in other liabilities in the accompanying consolidated balance sheets. During the fourth quarter of 2008, the agreements were amended for certain former and current executive officers. Under the terms of the amended agreements, these individuals agreed to accept specified accelerated payments based on a discount rate of 6.0%. The Bank made payments in January 2010 of \$72,000 under the amended agreements.

The Bank recognized a provision for deferred compensation of \$11,000 in 2012, \$16,000 in 2011, and \$2,000 in 2010.

No other postretirement or postemployment benefits are offered to retirees or employees.

#### **NOTE 16 - STOCK-BASED COMPENSATION**

The Corporation established in 2002 a Stock Option and Incentive Plan (the "2002 Plan") which permitted the awarding of stock options and/or stock appreciation rights to directors, managerial, and other key employees of the Corporation. The 2002 Plan, which provided for the issuance of up to 190,951 shares, expired in March 2012.

At the 2012 Annual Stockholders Meeting, the stockholders of the Corporation adopted the Croghan Bancshares, Inc. 2012 Equity Incentive Plan (the "2012 Plan"), which permits the Corporation to award stock options, stock appreciation rights, restricted stock, and other stock-based and performance-based awards to directors, employees, and other eligible participants. A total of 162,082 shares are available for issuance pursuant to the 2012 Plan.

The Corporation issued 28,869 options during 2011 at an exercise price of \$24.00 under the 2002 plan. Following is a summary of activity for stock options for the years ended December 31, 2012, 2011, and 2010:

|                                | 2012          | 2011   | 2010 |
|--------------------------------|---------------|--------|------|
| Outstanding, beginning of year | 28,869        | -      | _    |
| Granted                        | · -           | 28,869 | -    |
| Exercised                      | -             | -      | -    |
| Forfeited                      |               |        |      |
| Outstanding, end of year       | <u>28,869</u> | 28,869 |      |

The options vest over a three-year period on the anniversary date of issuance. At December 31, 2012, 9,623 options were exercisable with a weighted average remaining contractual term of 7 years.

The fair value of options granted is estimated at the date of grant using the Black Scholes option pricing model. Following are assumptions used in calculating the fair value of the options issued in 2011:

| Weighted-average fair value of options granted | \$<br>3.62 |
|------------------------------------------------|------------|
| Average dividend yield                         | 5.0%       |
| Expected volatility                            | 25.0%      |
| Risk-free interest rate                        | 2.85%      |
| Expected term (in years)                       | 8          |

Compensation expense related to issued stock options amounted to \$57,000 in 2012. As of December 31, 2012, there is \$46,000 of unrecognized compensation expense expected to be recognized over a period of two years.

Restricted stock awards may also be issued under the 2012 Plan. A summary of restricted stock activity for 2012 is as follows:

|                                | Shares       | Weighted<br>average<br>grant date<br>fair value |
|--------------------------------|--------------|-------------------------------------------------|
| Granted                        | 5,250        | \$31.21                                         |
| Vested                         | -            | -                                               |
| Forfeited                      |              |                                                 |
| Nonvested at December 31, 2012 | <u>5,250</u> | <u>\$31.21</u>                                  |

Compensation expense relating to restricted stock is recognized over the vesting period based on the market value of the shares on the issue date amounting to \$23,000 during the year ended December 31, 2012. As of December 31, 2012, there was \$142,000 of total unrecognized compensation cost related to unvested restricted stock awards. The cost is expected to be recognized over a weighted average period of five years. Restricted stock awards vest over a five year period.

#### NOTE 17 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its clients. These financial instruments are primarily loan commitments to extend credit and letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amounts recognized in the consolidated balance sheets. The contract amount of these instruments reflects the extent of involvement the Bank has in these financial instruments.

The Bank's exposure to credit loss in the event of the nonperformance by the other party to the financial instruments for loan commitments to extend credit and letters of credit is represented by the contractual amounts of these instruments. The Bank uses the same credit policies in making loan commitments as it does for on-balance sheet loans.

The following financial instruments whose contract amount represents credit risk were outstanding at December 31, 2012 and 2011 (dollars in thousands):

|                                                                                                                   | Contract amount |                 |
|-------------------------------------------------------------------------------------------------------------------|-----------------|-----------------|
|                                                                                                                   | 2012            | 2011            |
| Commitments to extend credit, including commitments to grant loans and unfunded commitments under lines of credit | <u>\$92,492</u> | <u>\$75,274</u> |
| Standby letters of credit                                                                                         | <u>\$ 1,619</u> | <u>\$ 1,519</u> |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the client. Collateral held varies but may include accounts receivable; inventory; property, plant, and equipment; and income-producing commercial properties.

Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party and are reviewed for renewal at expiration. At December 31, 2012, the Bank had outstanding standby letters of credit aggregating \$1,619,000, of which \$1,608,000 expire in 2013 and \$11,000 expire in 2014. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to clients. The Bank requires collateral supporting these commitments when deemed necessary.

#### **NOTE 18 - REGULATORY MATTERS**

The Corporation (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Corporation's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined in the regulations), and of Tier I capital to average assets (as defined in the regulations). Management believes, as of December 31, 2012 and 2011, that the Corporation and the Bank met all capital adequacy requirements to which they were subject.

As of December 31, 2012, the most recent notification from federal and state banking agencies categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized", an institution must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the following. There are no conditions or events since that notification that management believes have changed the Bank's category.

# NOTE 18 - REGULATORY MATTERS (CONTINUED)

The actual capital amounts and ratios of the Corporation and the Bank as of December 31, 2012 and 2011 are also presented in the following (dollars in thousands):

| •                                                                                     | Minimum<br>capital<br>Actual requirement |                | Minimum to be well capitalized under prompt corrective action provisions |                  |                  |                |
|---------------------------------------------------------------------------------------|------------------------------------------|----------------|--------------------------------------------------------------------------|------------------|------------------|----------------|
|                                                                                       | Amount                                   | Ratio          | Amount                                                                   | Ratio            | Amount           | Ratio          |
| As of December 31, 2012  Total Capital  (to Risk-Weighted Assets)  Consolidated  Bank | \$ 50,076<br>54,828                      | 14.2%<br>15.5% | \$ 28,273<br>28,245                                                      | ≥ 8.0%<br>≥ 8.0% | N/A<br>\$ 35,306 | N/A<br>≥ 10.0% |
| Tier I Capital<br>(to Risk-Weighted Assets)<br>Consolidated<br>Bank                   | 45,751<br>50,503                         | 13.0%<br>14.3% | 14,136<br>14,122                                                         | ≥ 4.0%<br>≥ 4.0% | N/A<br>21,184    | N/A<br>≥ 6.0%  |
| Tier I Capital<br>(to Average Assets)<br>Consolidated<br>Bank                         | 45,751<br>50,503                         | 7.6%<br>8.3%   | 24,239<br>24,225                                                         | ≥ 4.0%<br>≥ 4.0% | N/A<br>30,282    | N/A<br>≥ 5.0%  |
| As of December 31, 2011  Total Capital  (to Risk-Weighted Assets)  Consolidated  Bank | \$ 46,942<br>52,537                      | 13.3%<br>14.9% | \$ 28,195<br>28,167                                                      | ≥ 8.0%<br>≥ 8.0% | N/A<br>\$35,209  | N/A<br>≥ 10.0% |
| Tier I Capital<br>(to Risk-Weighted Assets)<br>Consolidated<br>Bank                   | 42,527<br>48,122                         | 12.1%<br>13.7% | 14,097<br>14,083                                                         | ≥ 4.0%<br>≥ 4.0% | N/A<br>21,125    | N/A<br>≥ 6.0%  |
| Tier I Capital<br>(to Average Assets)<br>Consolidated<br>Bank                         | 42,527<br>48,122                         | 8.4%<br>9.6%   | 20,164<br>20,150                                                         | ≥ 4.0%<br>≥ 4.0% | N/A<br>25,187    | N/A<br>≥ 5.0%  |

On a parent company only basis, the Corporation's primary source of funds are dividends paid by the Bank. The ability of the Bank to pay dividends is subject to limitations under various laws and regulations, and to prudent and sound banking principles. Generally, subject to certain minimum capital requirements, the Bank may declare a dividend without the approval of the State of Ohio Division of Financial Institutions, unless the total dividends in a calendar year exceed the total of its net profits for the year combined with its retained profits of the two preceding years. Under these provisions, \$4,392,000 was available for dividends on January 1, 2013, without the need to obtain the approval of the State of Ohio Division of Financial Institutions.

The Board of Governors of the Federal Reserve System generally considers it to be an unsafe and unsound banking practice for a bank holding company to pay dividends except out of current operating income, although other factors such as overall capital adequacy and projected income may also be relevant in determining whether dividends may be paid.

# NOTE 19 - CONDENSED PARENT COMPANY FINANCIAL INFORMATION

A summary of condensed financial information of the parent company as of December 31, 2012 and 2011 and for each of the three years in the period ended December 31, 2012 was as follows (dollars in thousands):

| CONDENSED BALANCE SHEETS                                                                                                                      |                               | 2012                                                  | 2011                                                  |
|-----------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------|-------------------------------------------------------|-------------------------------------------------------|
| Assets: Cash Dividends receivable from subsidiary Investment in subsidiary Available-for-sale security Other assets                           |                               | \$ 27<br>-<br>71,916<br>350<br>136                    | \$ 31<br>535<br>68,479<br>350<br>52                   |
| Total assets                                                                                                                                  |                               | <u>\$72,429</u>                                       | <u>\$69,447</u>                                       |
| Liabilities: Borrowed funds Dividends and other payables Total liabilities                                                                    |                               | \$ 5,199<br>66<br>5,265                               | \$ 6,000<br>564<br>6,564                              |
| Stockholders' equity: Common stock Surplus Retained earnings Accumulated other comprehensive income Treasury stock Total stockholders' equity |                               | 23,926<br>118<br>45,361<br>5,843<br>(8,084)<br>67,164 | 23,926<br>179<br>42,662<br>4,341<br>(8,225)<br>62,883 |
| Total liabilities and stockholders' equity                                                                                                    |                               | <u>\$72,429</u>                                       | <u>\$69,447</u>                                       |
| CONDENSED STATEMENTS OF OPERATIONS                                                                                                            | 2012                          | 2011                                                  | 2010                                                  |
| Income – dividends from subsidiary<br>Interest income on subordinated note from subsidiary<br>Professional fees, interest, and other expenses | \$3,252<br>-<br><u>(400</u> ) | \$2,317<br>190<br><u>(342</u> )                       | \$3,101<br>200<br>(134)                               |
| Income before income taxes and equity in undistributed net income of subsidiary                                                               | 2,852                         | 2,165                                                 | 3,167                                                 |
| Federal income tax provision (credit)                                                                                                         | <u>(136</u> )                 | <u>(52</u> )                                          | 22                                                    |
| Income before equity in undistributed net income of subsidiary                                                                                | 2,988                         | 2,217                                                 | 3,145                                                 |
| Equity in net income of subsidiary, less dividends                                                                                            | <u>1,855</u>                  | 2,537                                                 | <u>879</u>                                            |
| Net income                                                                                                                                    | <u>\$4,843</u>                | <u>\$4,754</u>                                        | \$4,024                                               |

NOTE 19 - CONDENSED PARENT COMPANY FINANCIAL INFORMATION (CONTINUED)

| CONDENSED STATEMENTS OF CASH FLOWS                                                                                                                        | 2012                   | 2011                         | 2010                          |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------|------------------------------|-------------------------------|
| Cash flows from operating activities:  Net income  Adjustments to reconcile net income to net                                                             | \$4,843                | \$4,754                      | \$4,024                       |
| cash provided by operating activities: Equity in net income of subsidiary, less dividends Decrease in dividends receivable Decrease (increase) in accrued | (1,855)<br>535         | (2,537)<br>1                 | (879)<br>12                   |
| interest receivable<br>Increase in other assets<br>Increase (decrease) in other liabilities                                                               | -<br>(84)<br>37        | 90<br>(52)<br><u>(10</u> )   | (65)<br>-<br><u>7</u>         |
| Net cash provided by operating activities                                                                                                                 | 3,476                  | 2,246                        | 3,099                         |
| Cash flows from financing activities: Principal payments on borrowed funds Cash dividends paid Purchase of treasury shares                                | (801)<br>(2,679)<br>—- | -<br>(2,142)<br><u>(76</u> ) | -<br>(2,174)<br><u>(940</u> ) |
| Net cash used in financing activities                                                                                                                     | (3,480)                | <u>(2,218</u> )              | (3,114)                       |
| Net increase (decrease) in cash                                                                                                                           | (4)                    | 28                           | (15)                          |
| Cash at beginning of year                                                                                                                                 | <u>31</u>              | 3                            | 18                            |
| Cash at end of year                                                                                                                                       | <u>\$ 27</u>           | <u>\$ 31</u>                 | <u>\$ 3</u>                   |

Under a program initially approved by the Board of Directors in 2002, the Corporation periodically purchased shares of its common stock in the over-the-counter market. During the first quarter of 2012, the Board of Directors opted not to renew the program.

#### **NOTE 20 - FAIR VALUE MEASUREMENTS**

ASC 820-10 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are independent, knowledgeable, and both able and willing to transact.

Nonfinancial assets and liabilities measured at fair value on a recurring basis include reporting units measured at fair value in the first step of a goodwill impairment test. Nonfinancial assets measured at fair value on a nonrecurring basis include nonfinancial assets and liabilities measured at fair value in the second step of a goodwill impairment test, as well as intangible assets and other nonfinancial long-lived assets measured at fair value for impairment assessment, such as other real estate owned.

#### **NOTE 20 - FAIR VALUE MEASUREMENTS (CONTINUED)**

ASC 820-10 requires the use of valuation techniques that are consistent with the market approach, the income approach, and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable or unobservable. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, ASC 820-10 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.

Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include: quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable for the asset or liability; and inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Unobservable inputs for the asset or liability for which there is little, if any, market activity at the measurement date. Unobservable inputs reflect the Corporation's own assumptions about what market participants would use to price the asset or liability. The inputs are developed based on the best information available in the circumstances, which might include the Corporation's own financial data such as internally developed pricing models, discounted cash flow methodologies, as well as instruments for which the fair value determination requires significant management judgment.

There were no financial instruments measured at fair value that moved to a lower level in the fair value hierarchy due to the lack of observable quotes in inactive markets for those instruments at December 31, 2012 and 2011.

The following summarizes financial assets (there were no financial liabilities) measured at fair value as of December 31, 2012 and 2011, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (dollars in thousands):

|                                     | Level 1 inputs | Level 2 inputs | Level 3 inputs       | Total<br>fair value |
|-------------------------------------|----------------|----------------|----------------------|---------------------|
| 2012                                |                |                |                      |                     |
| Recurring:                          |                |                |                      |                     |
| Securities available-for-sale:      |                |                |                      |                     |
| Obligations of U.S. Government      |                |                |                      |                     |
| agencies and corporations           | \$ -           | \$131,990      | \$ -                 | \$131,990           |
| Obligations of states and political |                |                |                      |                     |
| subdivisions                        | -              | 105,881        | -                    | 105,881             |
| Other                               |                | <u>350</u>     |                      | 350                 |
| Total                               | <u>\$ -</u>    | \$238,221      | <u>\$ -</u>          | <u>\$238,221</u>    |
| Nonrecurring:                       |                |                |                      |                     |
| Other real estate owned             | \$ -           | \$ -           | \$ 1,295             | \$ 1,295            |
| Impaired loans                      | <u> </u>       | <u> </u>       | 6,621                | 6,621               |
| Total                               | \$ <b>-</b>    | \$ -           | \$ 7,916             | \$ 7,91 <u>6</u>    |
| rotar                               | Ψ              | Ψ -            | $\frac{\Psi}{1,910}$ | $\Psi I, 910$       |

NOTE 20 - FAIR VALUE MEASUREMENTS (CONTINUED)

| 2011                                | Level 1 inputs | Level 2 inputs     | Level 3 inputs  | Total<br>fair value |
|-------------------------------------|----------------|--------------------|-----------------|---------------------|
| 2011 Recurring:                     |                |                    |                 |                     |
| Securities available-for-sale:      |                |                    |                 |                     |
| Obligations of U.S. Government      |                |                    |                 |                     |
| agencies and corporations           | \$ -           | \$137,244          | \$ -            | \$137,244           |
| Obligations of states and political |                |                    |                 |                     |
| subdivisions                        | -              | 87,688             | -               | 87,688              |
| Other                               |                | <u>350</u>         |                 | <u>350</u>          |
| Total                               | \$ -           | \$225,282          | \$ -            | <u>\$225,282</u>    |
|                                     | <del>*</del>   | <del>*==*,==</del> | <del></del>     | <del></del>         |
| Nonrecurring:                       |                |                    |                 |                     |
| Other real estate owned             | \$ -           | \$ -               | \$ 1,877        | \$ 1,877            |
| Impaired loans                      |                |                    | <u>15,876</u>   | <u> 15,876</u>      |
| Total                               | \$ -           | \$ -               | <b>\$17,753</b> | \$ 17,75 <u>3</u>   |
|                                     | Ψ              | Ψ                  | <u> </u>        | <u>Ψ 17,700</u>     |

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, follows:

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality, the Corporation's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Corporation's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Corporation's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

In connection with the branch acquisition described in Note 3, loans acquired of \$21,503,000 and deposits assumed of \$111,075,000 were recorded at their estimated fair values as of the December 16, 2011 closing date based on the present value of the future incremental cash flows. Certain inputs used in the calculations would be unobservable to a market participant, making them level 3 inputs.

### Securities Available-for-Sale

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would typically include government bonds and exchange traded equities. If quoted market prices are not available, then fair values are estimated using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, include corporate and municipal bonds, mortgage-backed securities, and asset-backed securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. The Corporation did not have any securities classified as Level 1 or Level 3 at December 31, 2012 and 2011.

## Impaired Loans

The Corporation does not record impaired loans at fair value on a recurring basis. However, periodically, a loan is considered impaired and is reported at the fair value of the underlying collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs, including recent appraisals and Level 3 inputs based on customized discounting criteria. Due to the significance of the Level 3 inputs, fair values of impaired loans have been classified as Level 3.

#### Other Real Estate Owned

The Corporation values other real estate owned at the estimated fair value of the underlying collateral less expected selling costs, generally approximating 10%. Such values are estimated primarily using appraisals and reflect a market value approach. Due to the significance of the Level 3 inputs, other real estate owned has been classified as Level 3.

#### **NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS**

The fair values of recognized financial instruments at December 31, 2012 and 2011 are as follows (dollars in thousands):

|                                                      | 2012               |                  | 2011               |                  |  |
|------------------------------------------------------|--------------------|------------------|--------------------|------------------|--|
|                                                      | Carrying<br>amount | Fair<br>value    | Carrying<br>amount | Fair<br>value    |  |
| FINANCIAL ASSETS                                     |                    |                  |                    |                  |  |
| Cash and cash equivalents                            | \$ 31,216          | \$ 31,216        | \$ 60,093          | \$ 60,093        |  |
| Securities                                           | 242,395            | 242,395          | 229,126            | 229,126          |  |
| Loans, net                                           | <u>316,952</u>     | 323,143          | <u>297,187</u>     | 302,984          |  |
| Total                                                | <u>\$590,563</u>   | <u>\$596,754</u> | <u>\$586,406</u>   | <u>\$592,203</u> |  |
| FINANCIAL LIABILITIES                                |                    |                  |                    |                  |  |
| Deposits Federal funds purchased and securities sold | \$511,940          | \$513,710        | \$501,837          | \$503,563        |  |
| under repurchase agreements                          | 32,344             | 32,344           | 40.861             | 39,932           |  |
| Borrowed funds                                       | <u> 15,199</u>     | 16,642           | 18,500             | 19,980           |  |
| Total                                                | <u>\$559,483</u>   | \$562,696        | <u>\$561,198</u>   | <u>\$563,475</u> |  |

The preceding summary does not include accrued interest receivable, cash surrender value of life insurance, dividends payable, and other liabilities which are also considered financial instruments. The estimated fair value of such items is considered to be their carrying amount.

The Bank also has unrecognized financial instruments which relate to commitments to extend credit and standby letters of credit. The contract amount of such financial instruments was \$94,111,000 at December 31, 2012 and \$76,793,000 at December 31, 2011. The fair value of such instruments is not considered significant since they represent commitments at current interest rates.

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

## **Cash and Cash Equivalents**

Fair value is determined to be the carrying amount for these items because they represent cash or mature in 90 days or less and do not represent unanticipated credit concerns.

# **Securities**

The fair value of available-for-sale securities is determined based on quoted market prices of the individual securities or, if not available, estimated fair value was obtained by comparison to other known securities with similar risk and maturity characteristics. Such value does not consider possible tax ramifications or estimated transaction costs. The fair value of restricted stock is considered to be its carrying amount.

#### Loans

Fair value for loans is estimated for portfolios of loans with similar financial characteristics. For adjustable rate loans, which re-price at least annually and generally possess low risk characteristics, the carrying amount is believed to be a reasonable estimate of fair value. For fixed-rate loans, the fair value is estimated based on a discounted cash flow analysis, considering weighted average rates and terms of the portfolio, adjusted for credit and interest rate risk inherent in the loans. Fair value for nonperforming loans is based on recent appraisals or estimated discounted cash flows. The estimated value of credit card loans is based on existing loans and does not include the value that relates to estimated cash flows from new loans generated from existing cardholders over the remaining life of the portfolio.

#### NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

#### **Deposit Liabilities**

The fair value of core deposits, including demand deposits, savings accounts, and certain money market deposits, is the amount payable on demand. The fair value of fixed-maturity certificates of deposit is estimated using the rates offered at year end for deposits of similar remaining maturities. The estimated fair value does not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the marketplace.

#### **Other Financial Instruments**

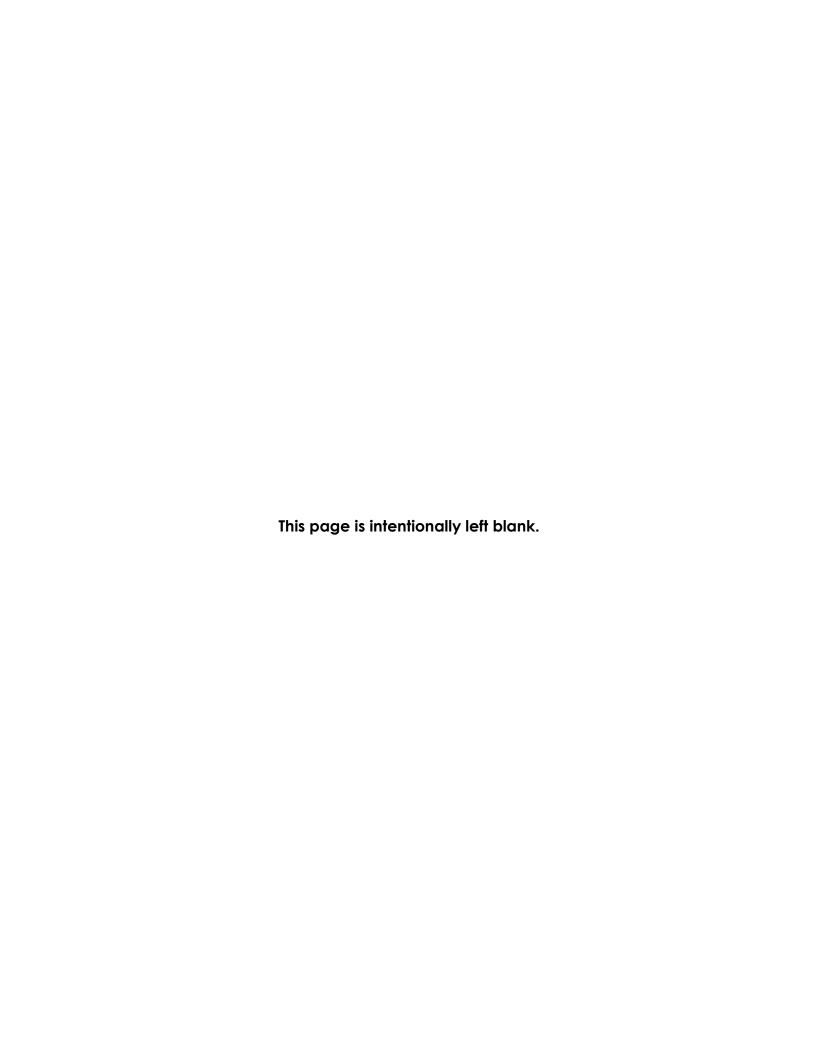
Federal funds purchased and securities sold under repurchase agreements are considered to be short-term borrowings and are valued at carrying value. Borrowed funds are typically long-term in nature with fair value determined based on discounted cash flow analysis using current interest rates.

The fair value estimates of financial instruments are made at a specific point in time based on relevant market information. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect these estimates.

#### **NOTE 22 - COMMITMENTS AND CONTINGENCIES**

The Bank has entered into multi-year agreements to lease certain of its facilities, as well as equipment under various short-term operating leases through June 2015. Rent expense under these agreements amounted to \$76,000 in 2012, \$116,000 in 2011, and \$140,000 in 2010. Future minimum lease payments under long-term operating leases aggregate \$119,000 at December 31, 2012 are as follows: 2013, \$53,000; 2014, \$46,000; and 2015, \$20,000.

In the normal course of business, the Corporation and Bank may be involved in various legal actions, but in the opinion of management and its legal counsel, the ultimate disposition of such matters is not expected to have a material adverse effect on the consolidated financial statements.



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# CORPORATE INFORMATION

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# **Common Stock Listing**

Croghan Bancshares, Inc. common stock is traded under the symbol:

CHBH

# **Annual Meeting**

The Annual Meeting of Shareholders will be held on Tuesday, May 14, 2013 1:00 pm (local time) at Terra Community College 2830 Napoleon Road Building B, Room 101 Fremont, Ohio 43420

