Arbor Bancorp, Inc.
2012 Annual Report

2011

2010

Record-setting financials for the third year in a row.

And, Ann Arbor.com's Company of the Year.

Dear Fellow Shareholders:

2012 was very successful—and somewhat bittersweet—at Bank of Ann Arbor.

We experienced, for the third consecutive year, record-setting financial performance. Many hellos. One sad goodbye. Valuable recognition both locally and nationally. And continued strong support for our community.

We welcomed many new clients, achieved record levels of total deposits and number of deposit accounts, and continued to support employment growth as we have for several years. In 2012, 22 new members of the Bank of Ann Arbor team brought invaluable experience and expertise with them. That brings the total to 150 employees. On Bank of Ann Arbor's first day of business in 1996, we had 15.

Sadly, we said goodbye to a dear friend and a founding director of Bank of Ann Arbor, Peter B. Fletcher, who passed away in September. Peter was an outstanding citizen of Washtenaw County whose tremendous enthusiasm for and support of Bank of Ann Arbor proved instrumental to our growth in the Ypsilanti area. He will be greatly missed.

Bank of Ann Arbor was named *AnnArbor.com*'s 2012 Company of the Year as a result of our "successful growth strategy over the past few years, strong earnings performance, noteworthy commitment to the community, and catchy marketing campaign." It's a tremendous acknowledgement of the work being done at the bank and in the community by all of our colleagues, the World's Best Bankers. We're the first financial institution to be so honored. *AnnArbor.com*'s Company of the Year is the highest annual recognition of the leading entrepreneurial and growth-oriented companies in our area.

Our long-running "Non-local banker" marketing campaign, created by Perich Advertising + Design, received attention both locally and nationally. The campaign was featured in *American Banker, AnnArbor.com, Ann Arbor Observer, Entrepreneur, Forbes, The Financial Brand* and *Independent Banker*. In three new TV commercials, a face—albeit an animated one—was put to the non-local banker's voice, heard until now exclusively in radio commercials.

We continued to use social media to strengthen the Bank of Ann Arbor brand and create new ways to give back to the community. With Project Help, our second charitable giving activity via social media (2011's award-winning Sweet 15 Local Charity Drive was the first) we contributed $40,000 to local non-profits for 15 much-needed projects. Voting by our Facebook followers, now totaling nearly 18,500, determined the projects we'd help fund. Then, a team of volunteers comprised of Bank of Ann Arbor employees and friends of the bank contributed their time, energy and skill to help complete the winning projects.

As always, the bank remains steadfast in its support of the arts, culture, and health and human services in the communities we serve. 2012 marked the fifth season of Sonic Lunch, our free summertime concert series in Ann Arbor's Liberty Plaza, which attracted record-setting attendance all season long. The highlight was a standing room only performance by Ann Arbor native Mayer Hawthorne, held in the Michigan Theater due to inclement weather.

But we are, after all, a bank, so we're particularly proud of our financial accomplishments in 2012, our third consecutive year of record-level performance. Some highlights:

Record deposits and assets. The sales team's efforts in expanding existing relationships and welcoming new clients to the bank led to 2012 deposit growth of $107 million to $793 million, a 16% increase. We're now, according to the FDIC, the third largest bank in Ann Arbor (we were fourth in 2011 and seventh in 2010). In the last three years, our total deposits have grown by $326 million, a 70% increase.

(In millions)	2012	2011	2010	2009
Total deposits	$793	686	609	466
Total assets	$891	774	689	542

Our deposit growth fueled an increase in total assets by $117 million, to over $890 million.

Record earnings and earnings per share. The increase in total assets combined with disciplined management of our operating expenses positively impacted earnings and earnings per share, as more assets helped generate net interest income. Despite the less-than-robust economy and net interest margin compression, we were able to grow earnings by nearly $1.9 million, or 28%, to $8.5 million, a record level. Earnings per share reached $9.62, up from $7.55 in 2011, resulting in a return on shareholders' equity of nearly 15%. This puts Bank of Ann Arbor in the top 6% of all banks in the country. The annual dividend paid to you, our valued shareholders, increased by 25% to $.80 per share, the highest in bank history. The remainder of our earnings was retained to support near-term growth and maintain regulatory capital levels. By year-end, our capital or shareholders equity had increased to nearly $59 million.

	2012	2011	2010	2009
Earnings (In millions)	$8,449	6,583	5,097	1,846
Earnings per share	$9.62	7.55	5.90	2.15

Record commercial, mortgage, and trust performance. A key component in our growth in net interest income levels was our strong commercial loan growth in 2012. Commercial loans outstanding, our highest earning asset, finished at $433 million, growth of nearly 10%. In addition, commercial, residential mortgage, and trust fee income all finished the year at record levels. Yes, our commercial, private banking, mortgage, trust and investments, and branch banking sales teams worked hard to grow the relationships with existing customers and to attract new customers. But their efforts were so much greater thanks to the behind-the-scenes work of every member of our internal team who helped make our growth seamless and well-managed.

Credit quality. According to the FDIC's most recent bank comparative report, Bank of Ann Arbor again outperformed other Michigan and U.S. banks in key metrics such as earnings coverage of net charge-offs, net charge-offs to total loans, and noncurrent loans to total loans. We also continue to see significant year-over-year improvement in a number of other credit quality metrics. This improvement allowed us to reduce our provision for loan loss in 2012 for the third consecutive year. Still, we kept our annual provision for mortgage loan buybacks at a level similar to 2011, but anticipate a lower provision for mortgage buybacks in the coming year as the housing market continues to stabilize.

According to the FDIC, we again outperformed other Michigan and U.S. banks in key metrics.

Exceptional results take hard work, to say the least, and hard work will be required going forward. We believe Bank of Ann Arbor and the entire banking industry will face stiff challenges in 2013, as margins continue to be compressed. Interest rates have been at unprecedented lows so most banks, including ours, have lowered deposit prices. But the low rates have also triggered a significant number of our longer-term assets, such as commercial loans, to be renewed at rates significantly lower than those at which the loans were originated. This will compress our net interest margin significantly. As in 2012, we must continue to make good loans and generate fee income to offset the compression we anticipate and continue to grow net interest income, though at a lower margin. We will also watch our operating expenses closely in order to continue to run a more efficient bank while always maintaining our dedication to providing exceptional customer service.

In January 2013, we proudly welcomed 15 employees of Ervin Leasing, which Bank of Ann Arbor acquired at the start of the year. The good news is that this exceptional company, founded in 1978, will remain local and locally owned. We plan to generously but judiciously fund the anticipated growth of Ervin Leasing, diversify its revenue sources, and add higher earning assets to the loan portfolio. Though we anticipate the acquisition will dilute our earnings in 2013, we believe it will contribute significantly to our earnings for years to come.

We extend a sincere and heartfelt thank you to everyone who helps Bank of Ann Arbor succeed on a day-to-day basis: Our employees, directors, shareholders, clients and the entire community. We look forward to overcoming the challenges we face—and enjoying our successes—together in 2013.

With our highly energized team of the World's Best Bankers, we will work extremely hard to deliver a fourth consecutive year of record-level performance.

Sincerely,

Tim Marshall

Timothy G. Marshall
President & CEO

Bill Martin

William C. Martin
Chairman of the Board

INDEPENDENT AUDITOR'S REPORT

Board of Directors and Shareholders
Arbor Bancorp, Inc.
Ann Arbor, Michigan

Report on the Financial Statements

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

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

Crowe Horwath LLP

Crowe Horwath LLP
Grand Rapids, Michigan
February 11, 2013

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2012 AND 2011

	2012	2011
ASSETS		
Cash and due from financial institutions	$ 19,804	$ 14,509
Federal funds sold	–	–
Interest-bearing balances in banks	118,944	109,532
Cash and cash equivalents	138,748	124,041
Securities available-for-sale	176,513	110,817
Loans held for sale	5,589	13,420
Loans, excluding covered loans, net	493,593	439,334
Covered loans	30,410	43,944
Total loans	524,003	483,278
Federal Home Loan Bank stock, at cost	2,634	2,634
Premises and equipment, net	12,214	10,534
Cash surrender value of life insurance	12,274	11,865
Other real estate owned	2,420	4,187
FDIC indemnification asset	6,277	7,726
Accrued interest receivable and other assets	10,216	5,713
	$890,888	**$774,215**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$ 212,191	$ 150,962
Interest-bearing	580,478	534,872
Total deposits	792,669	685,834
Federal Home Loan Bank advances	1,235	7,496
Repurchase agreements	21,482	21,652
Accrued expense and other liabilities	11,587	4,200
Subordinated debentures	5,155	5,155
Total liabilities	832,128	724,337
Shareholders' equity		
Common stock, no par value; 2,000,000 shares authorized; 887,784 and 875,004 shares issued and outstanding at December 31, 2012 and 2011	6,410	6,230
Retained earnings	49,302	42,090
Accumulated other comprehensive income/(loss)	3,048	1,558
Total shareholders' equity	58,760	49,878
	$ 890,888	**$ 774,215**

All dollar amounts in thousands except per share data. See accompanying notes.

CONSOLIDATED STATEMENTS OF INCOME
YEARS ENDED DECEMBER 31, 2012 AND 2011

	2012	2011
Interest income		
Loans, including fees	$ 28,940	$ 28,257
Securities:		
Taxable	1,217	1,434
Tax exempt	2,203	1,592
Federal funds sold and other	321	265
	32,681	31,548
Interest expense		
Deposits	1,917	2,635
Federal Home Loan Bank advances	74	129
Subordinated debentures	184	175
Repurchase agreements	98	64
	2,273	3,003
Net interest income	30,408	28,545
Provision for loan losses	2,500	3,350
Net interest income after provision for loan losses	27,908	25,195
Noninterest income		
Service charges on deposit accounts	462	517
Income from fiduciary activities	3,670	3,412
Net gains on sales of loans	2,034	4,728
Net gains on sales of securities	–	494
Gain (loss) on sales of OREO	464	(133)
Other	1,527	1,396
	8,157	10,414
Noninterest expense		
Salaries and employee benefits	14,018	14,680
Occupancy and equipment	1,915	2,098
Marketing and business promotion	1,044	916
FDIC expense	495	707
Provision for loan repurchase liability	2,400	2,967
Other	4,909	5,439
	24,781	26,807
Income before income taxes	11,284	8,802
Income tax expense	2,835	2,219
Net income	**$ 8,449**	**$ 6,583**
Basic earnings per share	$ 9.62	$ 7.55
Diluted earnings per share	8.97	7.21

See accompanying notes.

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

	2012	2011
Net income	$ 8,449	$ 6,583
Other comprehensive income:		
Unrealized gains/losses on securities:		
Unrealized holding gain/(loss) arising during the period	2,258	3,611
Reclassification adjustment for losses (gains) included in net income	–	(494)
Tax effect	(768)	(1,060)
Total other comprehensive income	1,490	2,057
Comprehensive income	**$ 9,939**	**$ 8,640**

See accompanying notes.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2012 AND 2011

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non-Controlling Interests	Total Shareholders' Equity
Balance, January 1, 2011	$ 5,750	$ 35,854	$ (499)	$ 371	$ 41,476
Net income	–	6,583	–	–	6,583
Other comprehensive income	–	–	2,057	–	2,057
Deferred shares plan	73	–	–	–	73
Liquidation of minority interest	–	–	–	(371)	(371)
Exercise of stock options (9,863 shares)	326	–	–	–	326
Issuance of 2,500 shares of common stock	105	–	–	–	105
Repurchase of 4,857 shares of common stock	(215)	–	–	–	(215)
Stock based compensation expense	191	–	–	–	191
Cash dividends paid (January) - $0.40 per share	–	(347)	–	–	(347)
Balance, December 31, 2011	6,230	42,090	1,558	–	49,878
Net income	–	8,449	–	–	8,449
Other comprehensive income	–	–	1,490	–	1,490
Deferred shares plan	31	–	–	–	31
Exercise of stock options (25,623 shares)	948	–	–	–	948
Repurchase of 19,453 shares of common stock	(1,215)	–	–	–	(1,215)
Stock based compensation expense	416	–	–	–	416
Cash dividend paid (January) $0.60 per share	–	(525)	–	–	(525)
Cash dividend paid (December) $0.80 per share	–	(712)	–	–	(712)
Balance, December 31, 2012	**$ 6,410**	**$ 49,302**	**$3,048**	**$ –**	**$ 58,760**

See accompanying notes.

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

	2012	2011
Cash flows from operating activities		
Net income	$ 8,449	$ 6,583
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	2,500	3,350
Depreciation	624	609
Stock-based compensation	416	191
Net amortization of securities	1,225	319
Increase in cash surrender value of life insurance	(409)	(399)
Loans originated for sale	(115,270)	(287,068)
Proceeds from loan sales	125,135	341,118
Net gains on sales of loans	(2,034)	(4,728)
Provision for loan repurchase liability	2,400	2,967
Net realized (gain) loss on sales of securities	–	(494)
Net change in:		
Other assets	(69)	9,038
Accrued expenses and other liabilities	4,250	(5,240)
Net cash from operating activities	27,217	66,246
Cash flows from investing activities		
Activity in available-for-sale securities:		
Sales	–	25,832
Maturities, prepayments and calls	32,310	43,591
Purchases	(96,973)	(124,043)
Proceeds from redemption of FHLB stock	–	293
Loan originations and payments, excluding covered loans	(57,688)	(81,886)
Net decrease in covered loans	11,796	11,695
Additions to premises and equipment, net	(2,304)	(2,000)
Decrease in FDIC indemnification asset	1,449	4,901
Net cash from investing activities	(111,410)	(121,617)
Cash flows from financing activities		
Net change in deposits	106,835	76,599
Net change in repurchase agreements	(170)	3,604
Dividends paid	(1,237)	(347)
Repayments on FHLB advances	(6,261)	(2,440)
Proceeds from exercise of stock options and sale of common stock	948	431
Repurchase of common stock	(1,215)	(215)
Net cash from financing activities	98,900	77,632
Net change in cash and cash equivalents	14,707	22,261
Beginning cash and cash equivalents	124,041	101,780
Ending cash and cash equivalents	**$ 138,748**	**$ 124,041**

(Continued)

CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
YEARS ENDED DECEMBER 31, 2012 AND 2011

	2012	2011
Supplemental cash flow information:		
Interest paid	$ 2,341	$ 3,307
Loans transferred to other real estate	2,667	2,498
Loans transferred to portfolio	2,998	8,774
Income taxes paid	3,700	5,695

See accompanying notes.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principles of Consolidation: The consolidated financial statements include Arbor Bancorp, Inc. and its wholly owned subsidiary, Bank of Ann Arbor, together referred to as "the Corporation." During 2011, the Bank's majority owned subsidiary, Progressive Mortgage Company LLC (Progressive), ceased operations and was liquidated. Intercompany transactions and balances are eliminated in consolidation.

The Bank provides financial services through its offices in Washtenaw and Wayne counties. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Other financial instruments, which potentially represent concentrations of credit risk, include deposit accounts in other financial institutions and federal funds sold. Progressive originated residential real estate loans for sale in the secondary market through a network of brokers located primarily in Michigan, Illinois, Indiana and Ohio. The Bank provided funding at closing for these loans which were all sold, service released in the secondary market.

Subsequent Events: The Corporation has evaluated subsequent events for recognition and disclosure through February 11, 2013 which is the date the financial statements were available to be issued.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, the reserve for repurchase of sold loans, the carrying amount of the FDIC Indemnification Asset and the fair values of financial instruments are particularly subject to change.

Cash Flows: Cash and cash equivalents includes cash, deposits with other financial institutions under 90 days, short-term investments and federal funds sold. Net cash flows are reported for customer loan and deposit transactions, federal funds purchased and repurchase agreements.

Interest-Bearing Deposits in Banks: Interest bearing deposits in banks mature within one year and are carried at cost. The balance outstanding at year end 2012 and 2011 was at the Federal Reserve Bank.

Securities: Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income. Interest income includes amortization of purchase premium or discount. Gains and losses on sales are based on the amortized cost of the security sold.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment (OTTI) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer and also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Federal Home Loan Bank (FHLB) Stock: The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Loans Held for Sale: Loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value, in the aggregate, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Loans are sold with servicing released. Buyers do not have recourse against the Corporation for subsequent loan losses. However, in certain situations, the buyer can require the Corporation to repurchase loans.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of purchase premiums and discounts and an allowance for loan losses.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term.

Interest income on all loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such 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.

Covered Loans: Loans acquired in 2010 in a Federal Deposit Insurance Corporation (FDIC)-assisted transaction are covered under a loss sharing agreement and are referred to as "covered loans." Pursuant to the terms of the loss sharing agreements, covered loans are subject to a stated loss threshold whereby the FDIC will reimburse the Corporation for 80% of losses incurred. The Corporation will reimburse the FDIC for its share of recoveries with respect to losses for which the FDIC paid the Corporation a reimbursement under the loss sharing agreement. The FDIC's obligation to reimburse the Corporation for losses with respect to covered loan begins with the first dollar of loss incurred.

Covered loans were recorded at fair value at the time of acquisition. Fair values for covered loans are based on a discounted cash flow methodology that considered various factors including the type of loan and related collateral, classification status, fixed or variable interest rate, term of loan and whether or not the loan was amortizing, and a discount rate reflecting the Corporation's assessment of risk inherent in the cash flow estimates. Covered loans were grouped together according to similar characteristics and were treated in the aggregate when applying various valuation techniques.

At purchase, certain covered loans had evidence of credit deterioration since origination. These loans are accounted for individually. The Corporation estimates the amount and timing of expected cash flows for each purchased loan, and the expected cash flows in excess of amount paid is recorded as interest income over the remaining life of the loan or pool (accretable yield). The excess of the loan's or pool's contractual principal and interest over expected cash flows is not recorded (nonaccretable difference). Over the life of the loan or pool, expected cash flows continue to be estimated. If the present value of expected cash flows is less than the carrying amount, a loss is recorded. If the present value of expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non classified loans and is based on historical loss experience adjusted for current factors.

A loan is impaired when full payment under the loan terms is not expected. Non-homogeneous loan classes such as commercial and commercial real estate loans and homogeneous loan segments, such as mortgage and consumer, are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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.

Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Corporation over the most recent three years. For the commercial land development segment of loans, an actual loss history of one year is used. For all segments, the actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified:

Commercial – Loans to businesses that are sole proprietorships, partnerships, limited liability companies and corporations. These loans are for commercial, industrial, or professional purposes. The risk characteristics of these loans vary based on the borrowers' business and industry as repayment is typically dependent on cash flows generated from the underlying business. Within this loan segment, the Corporation has identified loan classes of commercial and industrial, commercial real estate and commercial land development.

Real Estate – Loans to purchase or refinance single family residences. The risks associated with this segment are generally dependent on the overall real estate value environment and individual payment obligations. Real estate is subject to changes in market valuation and can be unstable for a variety of reasons. Within this segment the Corporation has identified classes of residential and home equity loans.

Consumer – Term loans or lines of credit for the purchase of consumer goods, vehicles or home improvement. The risk characteristics of the loans in this segment vary depending on the type of collateral but generally repayment is expected from a customer continuing to generate a cash flow that supports the calculated payment obligation. Secondary support could involve liquidation of collateral.

FDIC Indemnification Asset: The FDIC indemnification asset results from the loss share agreements in the FDIC-assisted transaction. The asset is measured separately from the related covered assets as they are not contractually embedded in the assets and are not transferable with the assets should the Corporation choose to dispose of them and represent the acquisition date fair value of expected reimbursements from the FDIC. Pursuant to the terms of the loss sharing agreement, covered loans are subject to a stated loss threshold whereby the FDIC will reimburse the Corporation for 80% of losses incurred. These expected reimbursements do not include reimbursable amounts related to future covered expenditures. These cash flows are discounted to reflect a metric of uncertainty of the timing and receipt of the loss sharing reimbursement from the FDIC. This asset decreases when losses are realized and claims are submitted to the FDIC or when customers repay their loans in full and expected losses do not occur. This asset also increases when estimated future losses increase and decreases when estimated future losses decrease. When estimated future loan losses increase, the Corporation records a provision for loan losses and increases its allowance for loan losses accordingly. The resulting increase in the FDIC indemnification asset is recorded as an offset to the provision for loan losses. During 2012 and 2011, the provision for loan losses was offset by $1,621 and $0 related to increases in the FDIC indemnification asset.

Other Real Estate Owned (OREO): Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed.

OREO acquired by the Corporation through loan defaults by customers on covered loans or acquired by the Corporation as part of its acquisition of New Liberty Bank are covered under the loss sharing agreement discussed above. Pursuant to the terms of the loss sharing agreement, covered assets are subject to a stated loss threshold whereby the FDIC will reimburse the Corporation for 80% of losses incurred. Any gains or losses realized at the time of disposal are partially offset by the FDIC loss share and are reflected in income. At year-end 2012 and 2011, $2,119 and $3,498 of the Corporation's OREO was subject to the loss sharing agreement.

Premises, Equipment and Leasehold Improvements: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation, generally computed on the straight-line basis over the assets' useful lives, and over the terms of the lease or the estimated useful lives for leasehold improvements, whichever is shorter.

Long-Term Assets: Premises and equipment, other intangible assets and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Repurchase Agreements: Substantially all repurchase agreement liabilities represent amounts advanced by various customers. These balances are not deposits and are not covered by federal deposit insurance. Securities are pledged to cover these liabilities.

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Corporation, 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 the Corporation does not maintain effective control over the transferred assets through an

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

agreement to repurchase them before their maturity.

Stock-Based Compensation: Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options.

Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense.

Off-Balance Sheet Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and standby letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Earnings Per Share: Basic earnings per share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under equity based plans. Earnings and dividends per share are restated for all stock splits and dividends through the date of issue of the financial statements.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale which are also recognized as separate components of equity.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Restrictions on Cash: Cash on hand or on deposit with the Federal Reserve Bank of $1,328 and $992 was required to meet regulatory reserve and clearing requirements at year end 2012 and 2011.

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Dividend Restriction: Banking regulations require maintaining certain capital levels and may limit the dividends paid by the bank to the holding company or by the holding company to shareholders.

Adoption of New Accounting Standards: In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in shareholder's equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective for annual reporting periods ending after December 15, 2012. The adoption of this amendment had no impact on the financial statements as the current presentation of comprehensive income is in compliance with this amendment.

NOTE 2 – BUSINESS COMBINATIONS

On January 1, 2013, the Corporation, through a newly established Bank subsidiary, Bank of Ann Arbor Leasing, acquired all of the stock of the Ervin Leasing Company (Ervin), an Ann Arbor, Michigan based leasing company which provides business equipment leases to companies across the United States. The purchase price for stock is the equity of Ervin at the date of acquisition plus $500. At acquisition, Ervin had outstanding leases of approximately $12,000 and notes payable of approximately $7,000. This acquisition

NOTE 2 – BUSINESS COMBINATIONS (continued)

will facilitate the Corporation's entry into the business leasing market and expand its geographic reach. As this acquisition occurred in 2013, the assets acquired, liabilities assumed and results of operations are not included in the 2012 financial statements of the Corporation.

On May 14, 2010, the Corporation entered into a purchase and assumption agreement (New Liberty Agreement) with the Federal Deposit Insurance Corporation (FDIC), as receiver, pursuant to which the Corporation acquired certain assets and assumed substantially all of the deposits and certain liabilities of New Liberty Bank (New Liberty). New Liberty operated one banking center in Plymouth, Michigan.

In connection with the New Liberty acquisition, the Corporation entered into a loss sharing agreement with the FDIC that covers most of New Liberty's assets, based upon the seller's records, including single family residential mortgage loans, commercial real estate and commercial and industrial loans, and OREO (collectively, covered assets). The loss sharing agreements are subject to certain servicing procedures as specified in agreements with the FDIC. The loss sharing agreements applicable to single family residential mortgage loans provide for FDIC loss sharing and Corporation reimbursement to the FDIC for ten years. The loss sharing agreements applicable to all other covered assets provide for FDIC loss sharing for five years and Corporation reimbursement of recoveries to the FDIC for eight years. The expected reimbursements under the loss sharing agreements were recorded as an indemnification asset at an estimated fair value of $15,949 on the acquisition date which represented the present value of the expected net cash reimbursement related to the loss sharing agreements.

The Corporation acquired certain other New Liberty assets not covered by the loss sharing agreement with the FDIC, including cash and securities purchased at fair value. At acquisition, in aggregate, loans acquired had an unpaid principal balance of $91,772 and a fair value of $69,069 and deposits assumed had a balance of $90,117.

NOTE 3 – SECURITIES

The fair value of available-for-sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2012				
U.S. Government and federal agency	$ 14,020	$ 41	$ 2	$ 14,059
Mortgage-backed securities: residential	53,309	609	311	53,607
Mortgage-backed securities: commercial	19,383	242	39	19,586
State and municipal	74,025	4,256	157	78,124
Corporate	11,157	7	27	11,137
	$ 171,894	**$ 5,155**	**$ 536**	**$ 176,513**
2011				
U.S. Government and federal agency	$ 18,050	$ 54	$ 11	$ 18,093
Mortgage backed securities: residential	20,760	147	31	20,876
Mortgage-backed securities: commercial	8,415	9	25	8,399
State and municipal	59,966	2,268	42	62,192
Corporate	1,265	–	8	1,257
	$ 108,456	**$ 2,478**	**$ 117**	**$ 110,817**

Sales of available-for-sale securities were as follows:

	2012	**2011**
Proceeds	$ –	$ 25,832
Gross gains	–	494
Gross losses	–	–

The fair value of available-for-sale securities at year-end 2012 by contractual maturity were as follows:

Due in one year or less	$ 6,873
Due from one to five years	18,207
Due from five to ten years	24,667
Due after ten years	53,573
Mortgage-backed securities	73,193
	$ 176,513

NOTE 3 – SECURITIES (continued)

Securities pledged at year-end 2012 and 2011 had a carrying amount of $35,928 and $36,184, and were pledged to secure repurchase agreements, FHLB borrowings and trust account deposits. At year-end 2012 and 2011, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity.

Securities with unrealized losses at year-end 2012 and 2011 not recognized in income are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
2012						
U.S. Government and federal agency bonds	$ 1,998	$ 2	$ –	$ –	$ 1,998	$ 2
Mortgage-backed: residential	24,252	311	–	–	24,252	311
Mortgage-backed: commercial	2,542	39	–	–	2,542	39
State and municipal	8,291	157	–	–	8,291	157
Corporate bonds	7,305	27	–	–	7,305	27
Total temporarily impaired	**$ 44,388**	**$ 536**	**$ –**	**$ –**	**$ 44,388**	**$ 536**
2011						
U.S. Government and federal agency bonds	$ 2,989	$ 11	$ –	$ –	$ 2,989	$ 11
Mortgage-backed: residential	6,867	31	–	–	6,867	31
Mortgage-backed: commercial	6,112	25	–	–	6,112	25
State and municipal	5,248	42	–	–	5,248	42
Corporate bonds	1,157	8	–	–	1,157	8
Total temporarily impaired	**$ 22,373**	**$ 117**	**$ –**	**$ –**	**$ 22,373**	**$ 117**

Unrealized losses on securities have not been recognized into income because the issuers are generally of high credit quality, management does not intend to sell and it is not more likely than not that management would be required to sell the securities prior to their anticipated recovery. Mortgage backed securities: residential consist primarily of securities issued by FNMA and 80% of the unrealized losses on those securities are on FNMA issued mortgage backed securities. The decline in fair value is largely due to changes in interest rates and is expected to recover as the securities approach maturity.

NOTE 4 – LOANS, including covered loans

Loans at year-end were as follows:

	2012	2011
Commercial:		
Commercial/Industrial	$ 109,585	$ 139,340
Commercial real estate	281,958	244,650
Commercial land development	15,023	3,071
Real estate:		
Residential	85,170	65,938
Home equity	30,875	32,690
Consumer	12,342	5,987
	534,953	491,676
Less allowance for loan losses	(10,950)	(8,398)
Loans, net	**$ 524,003**	**$ 483,278**

Loans to principal officers, directors, and their affiliates at year-end 2012 and 2011 were $11,533 and $13,381.

NOTE 4 – LOANS, including covered loans (continued)

The following table presents the activity in the allowance for loan losses by portfolio segment for the years ending December 31, 2012 and 2011:

	Commercial	Real Estate	Consumer	Total
December 31, 2012				
Allowance for loan losses:				
Beginning balance	$ 6,325	$ 1,775	$ 298	$ 8,398
Provision for loan losses (a)	4,254	76	(209)	4,121
Loans charged-off	(1,483)	(287)	(5)	(1,775)
Recoveries	197	9	–	206
Total ending allowance balance	**$ 9,293**	**$ 1,573**	**$ 84**	**$ 10,950**
December 31, 2011				
Allowance for loan losses:				
Beginning balance	$ 6,625	$ 1,355	$ 274	$ 8,254
Provision for loan losses (a)	2,637	672	41	3,350
Loans charged-off	(3,156)	(459)	(18)	(3,633)
Recoveries	219	207	1	427
Total ending allowance balance	**$ 6,325**	**$ 1,775**	**$ 298**	**$ 8,398**

(a) The provision for loan losses reflected on the consolidated statements of income is offset by increases in the FDIC indemnification asset resulting from increases in expected losses on covered loans. The provision for loan losses in 2012 and 2011 was offset by $1,621 and $0.

The following table presents the balance 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:

	Commercial	Real Estate	Consumer	Total
2012				
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 2,424	$ 185	$ 6	$ 2,615
Collectively evaluated for impairment	5,348	1,388	78	6,814
Acquired with deteriorated credit quality	1,521	–	–	1,521
Total ending allowance balance	**$ 9,293**	**$ 1,573**	**$ 84**	**$ 10,950**
Loans:				
Loans individually evaluated for impairment	$ 8,958	$ 1,296	$ 6	$ 10,260
Loans collectively evaluated for impairment	391,561	114,749	12,336	518,646
Loans acquired with deteriorated credit quality	6,047	–	–	6,047
Total ending loans balance	**$ 406,566**	**$ 116,045**	**$ 12,342**	**$ 534,953**
2011				
Allowance for loan losses:				
Ending allowance balance attributable to loans:				
Individually evaluated for impairment	$ 1,931	$ 35	$ 10	$ 1,976
Collectively evaluated for impairment	3,868	1,740	288	5,896
Acquired with deteriorated credit quality	526	–	–	526
Total ending allowance balance	**$ 6,325**	**$ 1,775**	**$ 298**	**$ 8,398**
Loans:				
Loans individually evaluated for impairment	$ 8,560	$ 1,009	$ 25	$ 9,594
Loans collectively evaluated for impairment	368,630	97,619	5,962	472,211
Loans acquired with deteriorated credit quality	9,871	–	–	9,871
Total ending loans balance	**$ 387,061**	**$ 98,628**	**$ 5,987**	**$ 491,676**

NOTE 4 – LOANS, including covered loans (continued)

The following table presents information related to impaired loans by class of loans as of and for the years ended December 31, 2012 and 2011:

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
December 31, 2012						
With no related allowance recorded:						
Commercial:						
Commercial/Industrial	$ –	$ –	$ –	$ –	$ –	$ –
Commercial real estate	990	990	–	996	63	60
Commercial land development	3,507	642	–	656	107	117
Real estate:						
Residential	358	358	–	365	10	11
Home equity	–	–	–	–	–	–
Consumer	–	–	–	–	–	–
Subtotal	4,855	1,990	–	2,017	180	188
With an allowance recorded:						
Commercial:						
Commercial/Industrial	4,077	3,307	1,263	3,400	297	297
Commercial real estate	5,743	5,039	1,549	5,544	218	229
Commercial land development	3,678	3,277	1,133	3,451	206	206
Real estate:						
Residential	969	931	179	947	16	15
Home equity	6	6	6	7	1	1
Consumer	6	6	6	8	2	2
Subtotal	14,479	12,566	4,136	13,357	740	750
Total	**$ 19,334**	**$ 14,556**	**$ 4,136**	**$15,374**	**$ 920**	**$ 938**
December 31, 2011						
With no related allowance recorded:						
Commercial:						
Commercial/Industrial	$ 845	$ 361	$ –	$ 468	$ –	$ –
Commercial real estate	1,172	716	–	1,002	9	6
Commercial land development	4,721	1,130	–	1,641	–	–
Real estate:						
Residential	635	509	–	575	4	2
Home equity	34	3	–	18	–	–
Consumer	8	3	–	14	2	2
Subtotal	7,415	2,722	–	3,718	15	10
With an allowance recorded:						
Commercial:						
Commercial/Industrial	1,809	1,638	471	1,826	70	69
Commercial real estate	4,830	4,374	1,432	4,528	209	196
Commercial land development	7,981	2,548	28	3,319	59	58
Real estate:						
Residential	1,128	1,001	27	1,076	3	2
Home equity	8	8	8	9	–	–
Consumer	69	25	10	43	1	1
Subtotal	15,825	9,594	1,976	10,801	342	326
Total	**$ 23,240**	**$ 12,316**	**$ 1,976**	**$14,519**	**$ 357**	**$ 336**

The recorded investment in loans excludes accrued interest receivable which is not material. For purposes of this disclosure, the unpaid principal balance is not reduced for partial charge-offs taken to date.

Nonperforming loans include nonaccrual loans and loans past due 90 days still on accrual. Nonperforming loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

NOTE 4 – LOANS, including covered loans (continued)

The following table presents the recorded investment in nonperforming loans by class of loans as of December 31, 2012 and 2011:

	2012		2011	
	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Nonaccrual	Loans Past Due Over 90 Days Still Accruing
Commercial:				
Commercial/Industrial	$ 263	$ –	$ 471	$ –
Commercial real estate	1,725	–	939	–
Commercial land development	826	–	1,909	–
Real estate:				
Residential	1,526	–	1,001	–
Home equity	15	–	8	–
Consumer	4	–	10	–
Total	**$ 4,359**	**–**	**$ 4,338**	**$ –**

The following table presents the aging of the recorded investment in past due loans as of December 31, 2012 and 2011 by class of loans:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 89 Days Past Due	Total Past Due	Loans Not Past Due	Total
December 31, 2012						
Commercial:						
Commercial/Industrial	$ –	$ –	$ 263	$ 263	$109,322	$109,585
Commercial real estate	118	–	1,725	1,843	280,115	281,958
Commercial land development	–	–	826	826	14,197	15,023
Real estate:						
Residential	106	–	1,526	1,632	83,538	85,170
Home Equity	177	130	15	322	30,553	30,875
Consumer	7	–	4	11	12,331	12,342
Total	**$ 408**	**$ 130**	**$ 4,359**	**$ 4,897**	**$530,056**	**$534,953**
December 31, 2011						
Commercial:						
Commercial/Industrial	$ –	$ –	$ 222	$ 222	$139,118	$139,340
Commercial real estate	126	93	713	932	243,718	244,650
Commercial land development	–	115	955	1,070	2,001	3,071
Real estate:						
Residential	–	492	249	741	65,197	65,938
Home Equity	37	202	–	239	32,451	32,690
Consumer	3	–	–	3	5,984	5,987
Total	**$ 166**	**$ 902**	**$ 2,139**	**$ 3,207**	**$488,469**	**$491,676**

Troubled Debt Restructurings:

The Corporation has allocated $769, and $1,152 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2012 and 2011. At year end 2011, approximately $1,000 relates to one loan relationship for which impairment is measured using the fair value of underlying collateral. The Corporation has not committed to lend material additional amounts to customers under troubled debt restructurings as of December 31, 2012 and 2011.

During the years ending December 31, 2012 and 2011, the terms of certain loans were modified in troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 2 months to 4 years. Modifications involving an extension of the maturity date were for similar periods.

NOTE 4 – LOANS, including covered loans (continued)

The following table presents loans by class modified as troubled debt restructurings that occurred during the years ending December 31, 2012 and 2011:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
2012			
Troubled debt restructurings:			
Commercial:			
Commercial/Industrial	5	$ 1,953	$ 1,953
Commercial real estate	4	286	286
Commercial land development	4	1,075	1,075
Real estate:			
Residential real estate	1	35	35
Home equity	2	9	9
Consumer	–	–	–
Total	**16**	**$ 3,358**	**$ 3,358**
2011			
Troubled debt restructurings:			
Commercial:			
Commercial/Industrial	6	$ 2,804	$ 2,804
Commercial real estate	3	1,272	1,272
Commercial land development	4	1,288	1,288
Real estate:			
Residential real estate	–	–	–
Home equity	1	4	4
Consumer	–	–	–
Total	**14**	**$ 5,368**	**$ 5,368**

The troubled debt restructurings described above increased the allowance for loan losses by $711 and $1,123 in 2012 and 2011. The restructurings did not result in a material amount of charge offs during the years ending December 31, 2012 and 2011. During 2012 and 2011, the Bank did not offer concessions to borrowers that reduced their accrued interest or principal amount owed.

There were no payment defaults on troubled debt restructurings during the years ended December 31, 2012 and 2011.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Corporation's internal underwriting policy.

Credit Quality Indicators:

The Corporation categorizes loans into risk categories based on relevant information about the ability of 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 Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes homogeneous and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a monthly basis. The Corporation uses the following definitions for risk ratings:

Watch. Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

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 so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

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

NOTE 4 – LOANS, including covered loans (continued)

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. Loans listed as not rated are included in groups of homogeneous loans.

Based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

	Pass	Watch	Substandard	Doubtful	Not Rated
December 31, 2012					
Commercial:					
Commercial/Industrial	$ 101,396	$ 6,113	$ 2,054	$ 22	$ –
Commercial real estate	274,230	1,653	6,075	–	–
Commercial land development	11,104	3,093	826	–	–
Real estate:					
Residential real estate	–	–	1,526	–	83,644
Home equity	–	99	17	–	30,759
Consumer	–	5	6	–	12,331
Total	**$ 386,730**	**$ 10,963**	**$ 10,504**	**$ 22**	**$ 126,734**
December 31, 2011					
Commercial:					
Commercial/Industrial	$ 129,098	$ 7,859	$ 2,261	$ 122	$ –
Commercial real estate	240,274	469	3,706	201	–
Commercial land development	–	825	1,474	772	–
Real estate:					
Residential real estate	–	–	1,001	–	64,937
Home equity	–	–	13	–	32,677
Consumer	–	–	10	14	5,963
Total	**$ 369,372**	**$ 9,153**	**$ 8,465**	**$ 1,109**	**$ 103,577**

The Corporation considers the performance of the homogeneous loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity:

	Real Estate		
	Residential	Home Equity	Consumer
December 31, 2012			
Performing	$ 83,644	$ 30,860	$ 12,338
Nonperforming	1,526	15	4
Total	**$ 85,170**	**$ 30,875**	**$ 12,342**
December 31, 2011			
Performing	$ 64,937	$ 32,682	$ 5,977
Nonperforming	1,001	8	10
Total	**$ 65,938**	**$ 32,690**	**$ 5,987**

NOTE 5 – COVERED LOANS

The Corporation evaluated covered loans purchased in conjunction with the acquisition of New Liberty pursuant to the provisions of FASB's accounting guidance for Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased impaired loans are subject to this guidance if there is determined to be evidence of credit deterioration, since origination, and if it is probable that not all contractually required payments will be collected. At the acquisition date, such loans had a contractual balance due of $30,132 and an estimated fair value of $19,800. The discount, substantially all of which was determined to be non-accretable based on the expected short-term resolution of the loans, represents expected credit impairment on the loans and is only recognized in income if the payments on the loan exceed the estimated payments.

NOTE 5 – COVERED LOANS (continued)

Purchased loans not deemed to be impaired had an acquisition date contractual balance due of $61,640 and an estimated fair value of $49,269.

All of these loans are subject to the loss share agreement with the FDIC pursuant to which 80% of contractual principal and up to 90 days of accrued interest is guaranteed.

As of December 31, 2012 and 2011, purchased impaired loans had contractual balances due of $8,735 and $13,332 and non accretable discounts of $2,688 and $3,461.

The FDIC Indemnification Asset represents the Corporation's estimate of the amount that will be due from the FDIC for its share of losses on covered loans and other real estate. The balance determined at acquisition was $15,949. As of December 31, 2012 and 2011, the balances were $6,277 and $7,726. This asset decreases when losses are realized and claims are submitted to the FDIC or when customers repay their loans in full and expected losses do not occur. This asset will also change when estimated future losses increase or decrease.

NOTE 6 – FAIR VALUE

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

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

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

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

The Corporation used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

Securities: Fair values are calculated based on market prices of similar securities (Level 2).

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at fair value, less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for a lower of cost or fair value less estimated costs to sell. Fair values are commonly based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Corporation. Management reviews the assumptions and approaches utilized in the appraisal. Management periodically evaluates the appraised values and will discount a property's appraised value to account for a number of factors including but not limited to the cost of liquidating the collateral, the age of the appraisal, observable deterioration since the appraisal, or other factors unique to the property.

NOTE 6 – FAIR VALUE (continued)

Assets and Liabilities Measured on a Recurring Basis: Assets and liabilities measured at fair value on a recurring basis, including financial assets and liabilities for which the Corporation has elected the fair value option, are summarized below:

	Fair Value Measurements at December 31, 2012 Using:			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets				
Securities available-for-sale				
U.S. government-sponsored entities and agencies	$ 14,059	$ –	$ 14,059	$ –
Mortgage backed securities: residential	53,607	–	53,607	–
Mortgage-backed securities: commercial	19,586	–	19,586	–
States and political subdivisions	78,124	–	78,124	–
Other securities	11,137	–	11,137	–
Total securities available-for-sale	**$ 176,513**	**$ –**	**$ 176,513**	**$ –**

	Fair Value Measurements at December 31, 2011 Using:			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets				
Securities available-for-sale				
U.S. government-sponsored entities and agencies	$ 18,093	$ –	$ 18,093	$ –
Mortgage backed securities: residential	20,876	–	20,876	–
Mortgage-backed securities: commercial	8,399	–	8,399	–
States and political subdivisions	62,192	–	62,192	–
Other securities	1,257	–	1,257	–
Total securities available-for-sale	**$ 110,817**	**$ –**	**$ 110,817**	**$ –**

Assets and Liabilities Measured on a Non-Recurring Basis: Assets measured at fair value on a non-recurring basis are summarized below:

	Fair Value Measurements at December 31, 2012 Using:			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans:				
Commercial:				
Commercial/Industrial	$ 2,044	$ –	$ –	$ 2,044
Commercial real estate	3,491	–	–	3,491
Commercial land development	2,095	–	–	2,095
Real Estate:				
Residential	752	–	–	752
Consumer	–	–	–	–
	$ 8,382	**$ –**	**$ –**	**$ 8,382**
Other real estate owned, net				
Commercial/Industrial	$ –	$ –	$ –	$ –
Commercial real estate	845	–	–	845
Commercial land development	247	–	–	247
	$ 1,092	**–**	**–**	**1,092**

NOTE 6 – FAIR VALUE (continued)

	Carrying Value	Fair Value Measurements at December 31, 2011 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans:				
Commercial:				
Commercial/Industrial	$ 936	$ –	$ –	$ 936
Commercial real estate	2,226	–	–	2,226
Commercial land development	1,390	–	–	1,390
Real Estate:				
Residential	466	–	–	466
Consumer	15	–	–	15
	$ 5,033	**$ –**	**$ –**	**$ 5,033**
Other real estate owned, net				
Commercial/Industrial	$ 1,485	$ –	$ –	$ 1,485
Commercial real estate	1,100	–	–	1,100
Commercial land development	1,602	–	–	1,602
	$ 4,187	**–**	**–**	**4,187**

As discussed previously, the fair values of impaired loans and other real estate carried at fair value are determined by third party appraisals. Management makes adjustments to these appraised values based on the age of the approasal and the type of the property. The following table presents quantitative information about level 3 fair value measurements for the larger classes of financial instruments measured at fair value on a non-recurring basis at December 31, 2012:

	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired loans				
Commercial				
Commercial/Industrial	$ 2,044	Sales comparison approach	Management discount for property type and recent market volatility	10%-100% (40%)
Commercial real estate	$ 3,491	Sales comparison approach	Management discount for property type and recent market volatility	10%-50% (35%)
Commercial land development	$ 2,095	Sales comparison approach	Management discount for property type and recent market volatility	10%-40% (30%)
Other real estate owned, net				
Commercial real estate	$ 845	Sales comparison approach	Management discount for property type and recent market volatility	5%-55% (30%)

NOTE 6 – FAIR VALUE (continued)

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had carrying amounts of $14,557 and $5,033 at year-end 2012 and 2011, which amounts are net of valuation allowances of $4,136 and $1,976 at year end 2012 and 2011, resulting in additional provisions for loan losses of similar amounts for the years.

Other real estate owned which is measured at the lower of carrying or fair value less costs to sell, had a carrying amount of $1,092 and $4,187 at year end 2012 and 2011. Write downs in 2012 and 2011 were $902 and $503.

Fair Value of Financial Instruments

Carrying amount and estimated fair values of financial instruments, not previously presented, at year end were as follows:

	2012		2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets				
Cash and cash equivalents	$ 138,748	$ 138,748	$ 124,041	$ 124,041
Loans held for sale	5,589	5,610	13,420	13,457
Loans, net	524,003	521,462	483,278	482,566
Federal Home Loan Bank stock	2,634	n/a	2,634	n/a
FDIC indemnification asset	6,277	n/a	7,726	n/a
Accrued interest receivable	1,358	1,358	1,599	1,599
Financial liabilities				
Deposits	$ 792,669	$ 792,828	$ 685,834	$ 686,204
Repurchase agreements	21,482	21,482	21,652	21,652
Federal Home Loan Bank advances	1,235	1,315	7,496	7,539
Subordinated debentures	5,155	5,155	5,155	5,155
Accrued interest payable	208	208	276	276

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

Carrying amount is the estimated fair value for cash and cash equivalents, interest bearing deposits, accrued interest receivable and payable, demand deposits, short term debt, and variable rate loans or deposits that reprice frequently and fully. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk, including estimated liquidity discounts for certain loans. Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock or the FDIC indemnification asset, due to restrictions placed on their transferability. The fair value of off-balance sheet items is not considered material.

NOTE 7 – PREMISES AND EQUIPMENT

Year-end premises and equipment were as follows:

	2012	2011
Land	$ 2,755	$ 2,287
Buildings	8,032	7,455
Leasehold improvements	3,730	3,472
Furniture, fixtures and equipment	6,636	5,864
	21,153	19,078
Less: accumulated depreciation	(8,939)	(8,544)
	$ 12,214	$ 10,534

Rent expense was $439 and $576 for 2012 and 2011. The main office and a branch facility are leased from a related party. Rental expense of $245 and $223 was attributable to a related party in 2012 and 2011. Rent commitments under noncancelable operating leases were as follows, before considering renewal options that generally are present.

2013	$ 283
2014	184
2015	107
2016	–
2017	–
	$ 574

NOTE 8 – DEPOSITS

Time deposits of $100 or more were $98,227 and $121,133 at year-end 2012 and 2011.

Scheduled maturities of time deposits for the next five years were as follows.

2013	$ 129,370
2014	8,714
2015	4,407
2016	1,924
2017	2,999
Thereafter	–
	$ 147,414

Deposits to principal officers, directors, and their affiliates at year-end 2012 and 2011 were $13,149 and $18,073.

NOTE 9 – FEDERAL HOME LOAN BANK ADVANCES AND SUBORDINATED DEBENTURES

At year-end, advances from the Federal Home Loan Bank were as follows.

	2012	2011
Maturities March 2013 through December 2017, with a contractual fixed rate of 4.30%.	$ 1,235	$ –
Maturities April 2012 through December 2016, with contractual fixed rates ranging from 4.3% to 4.57%, averaging 4.47%.	–	7,496
	$ 1,235	$ 7,496

Each advance is payable at its maturity date, with a prepayment penalty for fixed rate advances. Certain advances may be converted from a fixed rate to a variable rate, at certain points at the option of the Federal Home Loan Bank. These advances can be repaid, without penalty, at the time of such conversion. The advances were collateralized by $61,748 and $61,988 of mortgage loans at year end 2012 and 2011. Based on this collateral and the Corporation's holdings of FHLB stock, the Corporation is eligible to borrow up to a total of $60,596 at year end 2012.

FHLB advances at year-end 2012 include principal due of $1,152 and a yield adjustment related to the New Liberty acquisition of $83.

Contractual principal payment due are as follows:

2013	$ 160
2014	140
2015	122
2016	730
	$ 1,152

Subordinated Debentures and Trust Preferred Securities: During 2003, a trust formed by the Corporation issued $5,000 of floating rate trust as part of a pooled offering. The Corporation issued $5,155 in subordinated debentures to the trust in exchange for ownership of all of the common securities of the trust and the proceeds of the preferred securities issued by the trust. Interest is payable quarterly at a rate of LIBOR plus 3.15%, with a cap of 11.75%. The Corporation must repay the debentures prior to March 2033, but may call the debentures, without penalty, after March 2008. The trust is not consolidated into the Corporation's financial statements, but rather the subordinated debentures are shown as a liability. The Corporation's investment in the common stock of the trust is included in other assets.

NOTE 10 – INCOME TAXES

Income tax expense (benefit) was as follows:

	2012	2011
Current	$ 4,126	$ 3,077
Deferred	(1,291)	(858)
	$ 2,835	$ 2,219

Federal income tax expense differs from the amount computed by applying the U.S. federal statutory tax rate of 34% to income before taxes primarily due to the effect of tax-exempt interest income and increases in cash surrender value of life insurance.

A reconciliation of the differences between the federal income tax expense (benefit) recorded and the amount computed by applying the federal statutory rate to income before income taxes is as follows:

NOTE 10 – INCOME TAXES (continued)

	2012	2011
Tax at statutory rate (34%)	$ 3,836	$ 2,993
Increase (decrease) from		
Tax-exempt interest	(917)	(624)
Bank owned life insurance	(139)	(136)
General business credit	(114)	(115)
Other	169	101
Tax expense (benefit)	**$ 2,835**	**$ 2,219**

Year-end deferred tax assets and liabilities were due to the following.

	2012	2011
Deferred tax assets:		
Allowance for loan losses	$ 3,172	2,530
Deferred compensation	189	279
Depreciation	92	232
Post-retirement benefits	74	74
Purchase accounting adjustments	839	238
Other real estate	104	508
Repurchased mortgage loan settlements	1,565	998
Accrued retirement	238	161
Other	160	100
	6,433	5,120
Deferred tax liabilities:		
Loan fees	72	65
FHLB stock dividends	81	81
Net unrealized gain on securities available-for-sale	1,570	803
Prepaid expenses and other	53	38
	1,776	987
Net deferred tax asset	**$ 4,657**	**$ 4,133**

There were no unrecognized tax benefits at December 31, 2012, and the Corporation does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months. The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense, when applicable. The Corporation did not have any amounts accrued for interest and penalties at December 31, 2012. The Corporation and its subsidiaries are subject to U.S. federal income tax. The Corporation is no longer subject to examination by taxing authorities for years before 2009.

NOTE 11 – BENEFIT PLAN

The Corporation has a 401(k) plan that is a defined contribution savings plan for employees. Eligible employees may defer a portion of their salary. Employer contributions are discretionary and are determined annually by the Board of Directors. The Corporation's contribution expense was $491 and $442 for 2012 and 2011.

NOTE 12 – CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. Management believes as of December 31, 2012, the Corporation and Bank meet all capital adequacy requirements to which they are subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year end 2012 and 2011, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

NOTE 12 – CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS (continued)

The New Liberty FDIC-assisted transaction, which was accounted for as a business combination, resulted in the recognition of an FDIC Indemnification Asset, which represents the fair value of estimated future payments by the FDIC for losses on covered assets. The FDIC Indemnification Asset is risk weighted at 0% and the covered assets are risk-weighted at 20% for risk based regulatory capital requirement purposes.

Actual and required capital amounts and ratios are presented below at year end:

	Actual		Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2012						
Total Capital to risk weighted assets:						
Consolidated	$ 67,532	12.34%	$ 43,781	8.00%	$ n/a	n/a
Bank	66,907	12.24%	43,745	8.00%	55,285	10.00%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	60,616	11.08%	21,890	4.00%	n/a	n/a
Bank	59,997	10.97%	21,872	4.00%	33,171	6.00%
Tier 1 (Core) Capital to average assets:						
Consolidated	60,616	7.01%	34,590	4.00%	n/a	n/a
Bank	59,997	6.94%	34,590	4.00%	43,237	5.00%

	Actual		Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2011						
Total Capital to risk weighted assets:						
Consolidated	$ 59,464	11.89%	$ 40,017	8.00%	$ n/a	n/a
Bank	59,035	11.81%	39,977	8.00%	49,972	10.00%
Tier 1 (Core) Capital to risk weighted assets:						
Consolidated	53,183	10.63%	20,008	4.00%	n/a	n/a
Bank	52,760	10.56%	19,989	4.00%	29,983	6.00%
Tier 1 (Core) Capital to average assets:						
Consolidated	53,183	6.95%	30,605	4.00%	n/a	n/a
Bank	52,760	6.90%	30,605	4.00%	38,256	5.00%

NOTE 13 – LOAN COMMITMENTS AND RELATED ACTIVITIES

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance sheet risk was as follows at year-end.

	2012	**2011**
Commitments to make loans (at market rates)	$ 90,795	$ 82,483
Unused lines of credit and letters of credit	45,677	42,278

Commitments to make loans are generally made for periods of 60 days or less.

NOTE 13 – LOAN COMMITMENTS AND RELATED ACTIVITIES (continued)

Loans are sold with servicing released. Buyers do not have recourse against the Corporation for subsequent loan losses related to credit deterioration. However, in certain situations, the buyer can require the Corporation to repurchase loans based on underwriting exceptions. The Corporation reviews each repurchase request and asserts various defenses when such requests are made. A liability is established, included in accrued expense and other liabilities on the consolidated balance sheet, for the estimated risk of repurchase based both on past repurchase experience and on repurchase requests in the process of being evaluated. Repurchase losses and expense for 2012 and 2011 were as follows:

	2012	2011
Beginning balance	$ 2,935	$ 1,364
Provision charged to expense	2,400	2,967
Losses on loans repurchased	(732)	(1,396)
Ending balance	**$ 4,603**	**$ 2,935**

NOTE 14 – EARNINGS PER SHARE

The factors used in the earnings per share computation follow:

	2012	2011
Basic		
Net income	$ 8,449	$ 6,583
Weighted average common shares outstanding	878,342	872,243
Basic earnings per common share	$ 9.62	$ 7.55
Diluted		
Net income	$ 8,449	$ 6,583
Weighted average common shares outstanding for basic earnings per common share	878,342	872,243
Add: Dilutive effects of potential common stock equivalents	63,992	40,801
Average shares and dilutive potential common shares	942,334	913,044
Diluted earnings per common share	$ 8.97	$ 7.21

For 2012 and 2011, 51,030 and 66,192 options granted are not dilutive and have not been considered in computing earnings per share.

NOTE 15 – STOCK-BASED COMPENSATION

Share Award Plan

The Corporation maintains a deferred shares plan for directors which allows eligible directors to elect to defer all of their directors fees in return for Corporation stock. Under the Plan, deferred fees are used to accumulate shares of the Corporation's stock based on the stock price in effect at the time the fees are earned. Shares vest and are expensed immediately upon service provided, therefore there is no unrecognized compensation costs or unvested shares. Upon retirement or resignation, the stock is issued and distributed to the directors. At year-end 2012, 12,031 shares of Corporation stock (18,022 shares at year-end 2011) with an aggregate cost of $555 ($799 at year-end 2011) have been reserved for issuance. During 2012 and 2011, 6,570 and 441 shares were distributed.

Stock Option Plan

The Corporation has two stock option plans approved by shareholders. The Employee Share Option Plan permits the grant of share options to its employees for up to 285,000 shares of common stock. The 2011 Director Stock Compensation Plan permits the grant of share options to directors for up to 50,000 shares of common stock. The Corporation believes that such awards better align the interests of its employees and directors with those of its shareholders. The stock option plans are also designed to allow employees and directors to participate in the Corporation's future, as well as to enable it to attract, retain and award such employees and directors. Option awards are granted with an exercise price equal to the market price of the Corporation's common stock at the date of the grant, vesting periods of 3 year and 10 year contractual terms. The Corporation has a policy of using authorized, but unissued, shares to satisfy share option exercises. The Corporation has a right of first refusal to buy back option shares.

NOTE 15 – STOCK-BASED COMPENSATION (continued)

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination and forfeiture behavior. The Corporation expects that all options granted will vest and become exercisable. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The fair value of options granted was determined using the following weighted average assumptions as of grant date.

	2012	**2011**
Risk free interest rate	0.90%	2.09%
Expected term	5.0 years	5.0 years
Expected stock price volatility	28.78%	24.30%
Dividend yield	0.91%	1.0%

A summary of the activity in the stock option plan for 2012 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at beginning of year	174,809	$ 48.40		
Granted	27,530	66.07		
Exercised	(25,623)	37.01		
Forfeited or expired	(5,952)	59.81		
Outstanding at end of year	170,764	$ 50.88	5.8	$ 4,112
Exercisable at end of year	101,720	$ 53.17	4.4	$ 2,221

Information related to the stock option plan during each year follows:

	2012	**2011**
Intrinsic value of options exercised	$ 841	$ 122
Cash received from option exercises	948	326
Tax benefit realized from option exercises	–	–
Weighted average per share fair value of options granted	15.85	8.88

Total compensation cost that has been charged against income for this plan was $416 and $191 for 2012 and 2011, respectively. No income tax benefit was recognized. As of December 31, 2012, there was $786 of unrecognized compensation cost related to non-vested stock options granted under the Plan. That cost is expected to be recognized over a weighted-average period of 1.4 years. All options granted are expected to vest.

The Bank of Ann Arbor Team

Executive Management

Timothy G. Marshall
President &
Chief Executive Officer

Charles E. Crone, Jr.
First Vice President,
Commercial Banking
Group Manager

Lyle F. Dahlberg
First Vice President,
Trust & Investment
Group Manager

Patti H. Judson
First Vice President,
Branch Administration,
Operations &
Cash Management

Cynthia J. Livesay
First Vice President,
Credit Administration

Mark J. Slade
First Vice President &
Chief Financial Officer

Retail Banking

Patti H. Judson
First Vice President,
Branch Administration,
Operations &
Cash Management

Joan C. Hendricks
Vice President &
Main Office Branch Manager

Christine G. Johnson
Vice President,
Cash Management

Kristina L. Mayer
Vice President &
Plymouth Branch Manager

Russell D. Hines, Jr.
Stadium Office Branch Manager

David K. Pate
Ypsilanti Office Branch Manager

Shelley L. Rankin
Saline Office Branch Manager

Dennis D. Ticknor
Ellsworth Office Branch Manager
& Health Savings
Account Specialist

Sandra L. Beever
Deposit Operations Officer

Sandra M. Ross
Senior Relationship
Banking Officer

Kimberly K. Snow
Relationship Banking &
Cash Management Officer

Mortgage

Kirsty E. Haboian
Vice President &
Mortgage Department Manager

Charles W. Cracraft
Vice President,
Retail Mortgage Sales Manager

Kimberly A. Clugston
Vice President &
Senior Mortgage Loan Officer

Carl D. Ent
Vice President &
Mortgage Loan Officer

Joseph Craigmile
Mortgage Loan Officer

Kevin C. Salley
Mortgage Loan Officer

Private Banking Services

Maryanne B. Dunleavy,
Senior Vice President &
Private Banking Manager

Linda S. Brewer
Vice President &
Private Banking Officer

Mary Hays
Vice President &
Private Banking Officer

Trust and Investment Management

Lyle F. Dahlberg
First Vice President,
Trust & Investment
Group Manager

Thomas R. Kallewaard
First Vice President &
Senior Trust Officer

Sonia S. Patel
Senior Vice President &
Investment Officer

Cathleen L. Savoie
Senior Vice President &
Investment Officer

Stephen J. Seymour
Senior Vice President &
Senior Investment Officer

Erin E. Archambault
Vice President, Trust Operations

Eric P. Helber
Vice President &
Director of Business Development

Deborah A. Jones
Vice President &
Business Development Officer

Sandra S. Taggie
Vice President & Trust Officer

Margaret L. Vogel
Vice President & Trust Officer

Jacqueline Jenkins
Assistant Vice President,
Portfolio Manager & Business
Development Officer

Mitzi J. Talon
Assistant Vice President &
Trust Officer

Mark A. Skiff
Investment Officer

Finance and Compliance

Mark J. Slade
First Vice President &
Chief Financial Officer

John E. Foster
Vice President,
Security, Compliance &
BSA Officer

Margaret M. Lamb
Vice President & Controller

Barbara L. Morrison
Vice President

Bella M. Fernandez
Assistant Vice President & Accounting Officer

Cynthia K. Shaeffer
BSA/Security/Compliance Administrative Officer

Commercial Lending

Charles E. Crone, Jr.
First Vice President, Commercial Banking Group Manager

Walter G. Byers
President, Saline District

Michael L. Michon
President, Plymouth District

Patrick A. Tamblyn
President, Ypsilanti District

Michael A. Cole
Group President, Technology Industry Group

Hans W. Maier
Senior Vice President, Specialty Banking

Satish B. Jasti
Vice President & Senior Loan Officer

Robert R. Rose
Vice President & Senior Loan Officer

Mark D. Baily
Vice President & Commercial Loan Officer

Jonathon F. Bowdler
Vice President & Commercial Real Estate Manager

Michelle M. Burger
Vice President & Commercial Loan Officer

Mark H. Holtz
Vice President, Technology Industry Group

James J. Plummer
Vice President & Commercial Loan Officer

Information Systems

Jeffrey J. Stanton
Vice President & Chief Technology Officer

Essi E. Weber
Senior Technical Analyst & Technology Officer

Human Resources and Marketing

James A. Miller
Vice President & Director, Human Resources

Rhonda J. Foxworth
Vice President & Marketing Department Manager

Credit Administration

Cynthia J. Livesay
First Vice President, Credit Administration

Dawn M. Prescott
Senior Vice President & Managed Assets Officer

Trina M. VanNest
Assistant Vice President & Credit Administration Officer

Sara L. Simon
Assistant Vice President & Small Business Lending Officer

Stephanie N. Harrigan
Assistant Vice President, Consumer Credit & Compliance

Pamela J. Wetzel
Credit Administration Officer

Directors

Thomas P. Borders
President, Midtown Group, Inc.

Richard P. Eidswick
Founding Director, Arbor Partners

Jan L. Garfinkle
Founder & Managing Director, Arboretum Ventures

Isadore J. King
President & Chief Executive Officer, Synergy Partners, LLC

Timothy G. Marshall
President & Chief Executive Officer, Bank of Ann Arbor

Michael C. Martin
Vice President, First Martin Corporation

William C. Martin, Chairman
Athletic Director Emeritus, University of Michigan

Ernest G. Perich
President, Perich + Partners, Ltd.

David R. Sarns
Managing Partner, 360 Advisors, LLC

Joseph A. Sesi
Owner, Sesi Motors, Inc.

Cynthia H. Wilbanks
Vice President for Government Relations, University of Michigan

Jeffrey S. Williams
Chairman & Chief Executive Officer, Tangent Medical Technologies Molecular Systems Corporation

Directors Emeritus

James W. Anderson, Jr.
President, The Anderson Associates

Jan Barney Newman
Vice President, Ann Arbor District Library Board

Richard N. Robb, DDS
Regent Emeritus, Eastern Michigan University

In Memorium

Peter B. Fletcher

boaa.com

It is the mission of Bank of Ann Arbor to be a dynamic, growing and sustainable community bank that is the premier financial institution within the markets it operates; it will be owned by individuals in its markets, managed locally, and responsive to the needs of its communities. The Bank will serve and partner with its customers and communities to achieve their financial goals through high quality products delivered by energized employees and through community service comprised of donations, time, and leadership. Our shareholders will achieve superior long-term value; our employees are valued and will work in a culture that invests in their development and rewards their positive contributions.

Branch Offices

Downtown Ann Arbor 125 S. Fifth Avenue Ann Arbor, 48104 734-662-1600	**Ellsworth Rd. & Airport Blvd.** 801 W. Ellsworth Road Ann Arbor, 48108 734-669-8900	**Traver Village Shopping Center** 2601 Plymouth Road Ann Arbor, 48105 734-662-3800
Downtown Saline 179 E. Michigan Avenue Saline, 48176 734-470-5001	**Plymouth** 1333 W. Ann Arbor Road Plymouth, 48170 734-455-1511	
Downtown Ypsilanti 7 W. Michigan Avenue Ypsilanti, 48197 734-485-9400	**Stadium & Liberty** 2204 W. Stadium Boulevard Ann Arbor, 48103 734-822-1900	