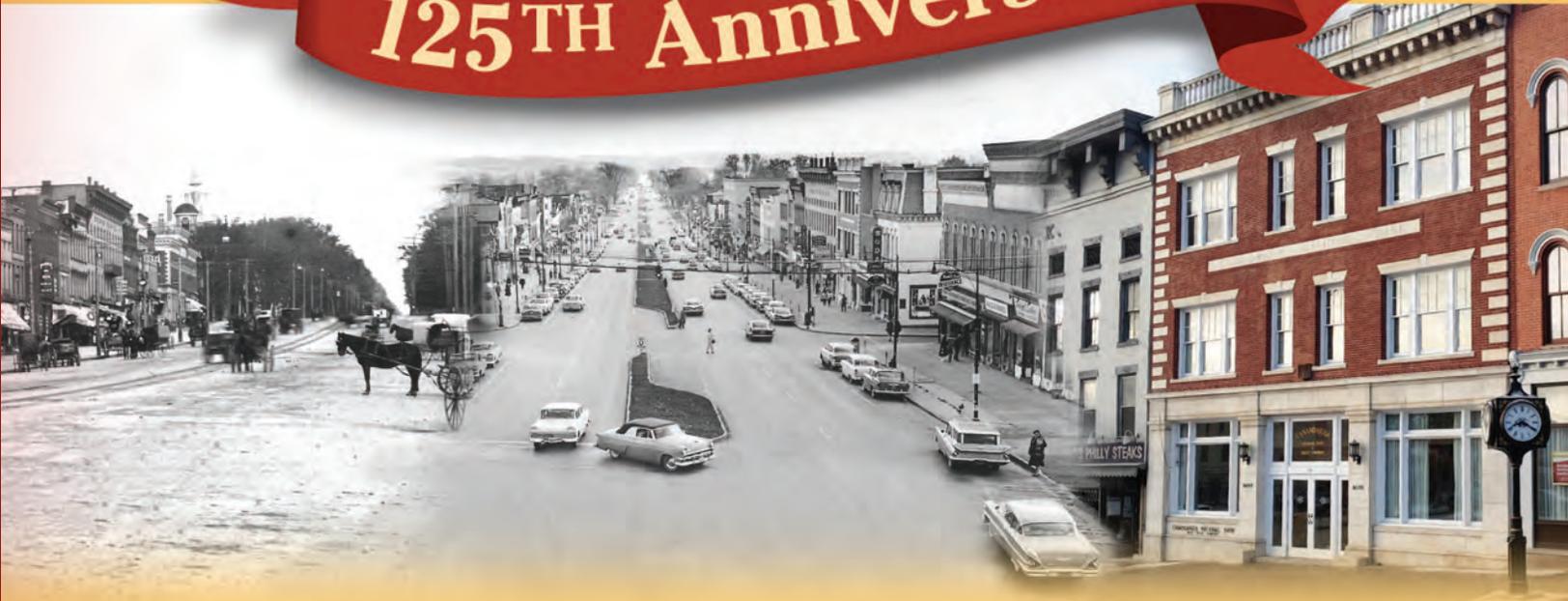


125TH Anniversary



Celebrating our legacy. Securing our future.

investing
in you



Canandaigua
National
Corporation

2012 ANNUAL REPORT AND FINANCIAL STATEMENTS

HONESTY • INTEGRITY RESPONSIBILITY TEAMWORK • RESPECT • INNOVATION PROFESSIONALISM COMMITMENT

Canandaigua National Bank and Trust's 125th year: our commitment is the constant.

As the country careened toward the “fiscal cliff” and Wall Street endured economic storms, the outlook on Main Street in Canandaigua continued to be bright—with a milestone year that reflected our legacy of strength, stability, and sustainability under any conditions.

In fact, during the past five recessions, we've seen an inflow of new deposits and accounts, leading to more lending and better earnings—in stark contrast to the losses that many banks experienced. That's due to the proven principles of quality loan underwriting and relationship building, which has been our philosophy for 125 years.

In 2012, we were agile and responsive to every challenge. We forged an exceptional year of commercial and consumer lending; formed new relationships with customers whose “local” bank had left town; trained officers and managers in small-business dynamics to better serve that segment; embraced innovative technology; and delivered the superior customer experience for which we're known.

As always, our strength lies in our choice to invest in diverse assets far removed from the frenzied markets and speculators on Wall Street. We would rather invest in enterprises that generate long-term benefits for our shareholders, customers, colleagues, and community.

January 21, 2013

A message from
George W. Hamlin, IV,
Chairman and CEO



To Our Shareholders:

December 1, 2012, marked the 125th anniversary of our first day of business as the Canandaigua National Bank in 1887. December 1, 1887, was a Thursday. The bank had agreed to rent property on Main Street for 10 years from the First National Bank of Canandaigua which had vacated its premises on the previous Friday having elected to go out of business (voluntarily). Prior to 1887, Canandaigua had been served by 12 banks with varying degrees of success. A few failed; some went out of business when their charters expired; while others went into voluntary liquidation—as it was for the First National which had served the community well for some 23 years. It was formed in 1864 and at first was located on the east side of Main Street until 1882 when it moved to new quarters on the west side at the location which today is occupied by a branch of Chase Bank, formerly Chase Lincoln First Bank, now a part of JPMorgan Chase & Co, but for years was known simply as the “lower bank” and we as the “upper bank.” There was no connection between either the ownership or operations of the two banks despite the somewhat similar cast of their names. Though interestingly, the name of the largest depositor on that first day was that of H. P. Ferguson, Cashier of the First National Bank, which was an active account until October 18, 1890, when a zero balance indicated that the liquidation was complete.

The very first depositor of Canandaigua National Bank listed in the enormous original ledger was the Ontario Orphan’s Asylum of which Frank H. Hamlin, our first President, was Treasurer, which was known later as the Ontario Children’s Home and continues today as a customer of the bank in the form of the Ontario Children’s Foundation. The foundation continues to underwrite activities and scholarship of the youth of the county through the offices of our Wealth Strategies Group. To complete the journey, in 1897 our banking office was moved to the northwest corner of Coy and Main Street at an annual rental of \$600! Finally, on November 7, 1914, the bank moved from its rented quarters on the corner of Coy Street to its newly purchased business location just up the block at 72 South Main Street, our Home Office ever since.

We occupied then the southern half of the ground floor with the other half being rented as a jewelry store. The space was modified to include the construction of two vaults: one in the basement and the other at the back of the first floor lobby, which was outfitted with a used vault door of the model which withstood the Atomic attack at ground zero in Hiroshima at the end of WW II three decades later. The second floor was used for law offices (Hamlin & Hamlin, among others) from whence I am writing these remarks in a newly refurbished suite, while the third floor was residential and now houses our Marketing Department and other services.

As a side note, for many years an “iconic” clock was located in front of Lincoln Rochester (lower bank), erected in the mid-1930s as a “symbol” of “endurance in time” of a grand display in the depth of the Great Depression. This stood until 2008, when one weekend in March, an “ill-wind of great fury” toppled the clock! This occurred during the same weekend that Bear-Stearns, one of the great investment banks of Wall Street, filed for bankruptcy and was rescued (purchased) by none other than JPMorgan Chase & Co! Really, the “iconic clock” in front of the branch of JPMorgan Chase & Co in Canandaigua blows over just as Bear-Sterns is “blown away” in ruin and is bought out of bankruptcy by JP Morgan with the aid of the Federal Reserve all in the same weekend!

What irony and high drama this presented as a grand metaphor for the “economic storm that ravaged Wall Street” and the chaos and bailouts of the Mega-Banks and their investment banking operations that followed. Bear-Stearns was the first shock to place the world on notice of the seriousness that was to crush other investment banks and Mega-Banks, all part of what would

turn out to be the Great Recession of 2007-2009. Imagine that all of this played out on the Main Street in Canandaigua as symbolized by the collapse of the clock at the very door step of a Wall Street bank's branch in direct "competition" with us on our "Main Street." The very next day, a flatbed truck drew up to the curb of the lower bank and a crew struggled to lift the entire fallen clock and pedestal structure onto the flatbed. They repaired and patched with the concrete the "tear" in the sidewalk, by trowelling over the hole and making it disappear, and spirited it all away as fast as they arrived. This was all without a "howdy do" or comment from the crew which returned nary a reply to Ken, the Hot Dog Man's, query, "Are you going to replace the clock?" It seems the silence of the concrete, smoothly troweled and setting-up covering the hole left by the clock's base whose rusted bolts gave way, was Ken's final answer. But opportunity springs from nowhere sometimes.

As soon as I had returned from a bank affiliation program in Boston and understood from my friend and customer Ken what had occurred beside his hotdog cart in front of the lower bank, we immediately set in motion the lengthy city and state permit processes to erect our own "iconic clock," emblematic of our "sustainability and endurance over time" gracing and completing (I would say) the streetscape in front of the Home Office—a trophy of a sort, ensconced where it should be at 72 South Main Street. But this is not about winning. It is about how you play the game and win. Our success has always been because of how we play and how our culture buoys our enterprise, but more on that subject later.

By way of providing context for the discussion that follows, the events of that weekend which "kicked off" the spiral of economic downturn, it was JPMorgan Chase & Co on March 7-8, 2008, who "won" the prize as negotiated by friend, Tom German, General Counsel for the Federal Reserve Bank of New York and backed by the Federal Reserve who fashioned the historic deal to buy Bear Stearns for \$2 a share representing 1% of the firm's former value at its record close just 14 months earlier after being a pillar for 85 years of Wall Street's mission as the primary market providing fresh new capital to businesses. Capital formation is generally accepted as the principal economic mission of Wall Street involving allocating investment capital to the most promising industries and companies, both those existing businesses that seek to provide better goods and services as well as innovators of new businesses altogether who seek to do the same, only de novo. The overwhelming consensus among academic economists is that this function of new capital formation provides the rationale for our financial system—the capitalist system which for all of its warts and blemishes, in the words of *The Economist* magazine, since 1843, has raised more populations and societies out of misery and despair than any political subdivision by providing the means by which individuals enfranchised thereby have the opportunity to flourish and provide for their families and communities by realizing on their dreams on their own efforts and determinations. So, where did Wall Street and the Mega-Banks and investment houses that dominated finance go "Off the Tracks" and how does that affect the future of our society? And what are the implications for Canandaigua National Bank/ Canandaigua National Corporation, a tested and proven effective player throughout this market cycle posting a successful performance consistently in each and every year of the last five?

The Year at Hand—2012

During a milestone year, there were many opportunities to give pause to reflect upon where we have come from, where we are today and why, and what the future may hold for us. This musing was laid in the context the fourth year of a too deliberate recovery for most, which to us a year ago posed a challenge for the prospects of revenue growth due to the extremely low interest rates and tenuous growth in loan demand reflective of the moderate growth of the economy to be expected. There is a truism that a bank can only reflect its environment, namely the health of the economic environment of commerce and consumption in its market; thus to achieve improved profitability, we were going to turn internally to two main priorities: 1) growth in wallet share of existing relationships, and 2) improvements in our operation's efficiency. Therefore, major corporate-wide projects revolving around these themes focused on synergy groups, implementation of an improved customer relationship management "CRM" system (to manage the quality of our customer relationships) with back office process

improvements, paper reduction (e-records), and mobile computing initiatives. I would defer to Frank's President's Letter for discussion of these and other interesting initiatives we have undertaken under his effective leadership.

If that were not enough, the tsunami of new banking regulations from the Consumer Financial Protection Bureau (CFPB), Comptroller of the Currency (OCC), and Federal Reserve continued throughout the year delivering "boxes of regulations" for our review and implementation numbering in the tens of thousands of pages. And of course, in an election year, the president and each party were at loggerheads regarding the "fiscal cliff and sequestration" threatening to "torpedo" the economy and raising the prospect of a second recession in combination causing unprecedented uncertainty for reasonable planning for 2013 by consumers and businesses alike.

Our Response to These Historical Times

We were no exception and seized the moment in the closing weeks of the year by undertaking maneuvers unprecedented in our long and rich history of remaining alert and adaptive in uncertain times. First, we moved to accelerate the usual February 2013 dividend five weeks earlier to be paid December 27, 2012. In addition, we gave the option to our Executive Team to elect to accelerate 90% of their incentive bonuses for performance in 2012, accrued by the company in 2012, but usually deferred and paid in February of the New Year after the final audit is completed. These actions were brought on by the hopelessly ambiguous state of the likely tax rules. Congress had "kicked the can down the road" rather than to resolve and compromise a deal by mid-December which was not completed on time, causing *The Economist* magazine to feature on its cover for the first issue of 2013 President Obama in a French beret clutching a baguette of French bread in the foreground, with Speaker Boehner in lederhosen in the semi left background with the U.S. Capitol Building centered in the background captioned "America Turns European" (a broken system, a lousy deal and no end in sight . . .) January 5-11, 2013 edition. Wow, the Brits do not mince their words, do they! But, who's to say they didn't nail it spot on!

Congress Misses the Deadline for the Entire World to See

And so it was that New Year's Day 2013 was spent watching parades and the college bowl games, but, not to be outdone, Congress played its own "bowl" game on January 1st with the first "touchdown" at 2:00 a.m. New Year's Day, when the Senate passed "the Bill" just covering the tax issues of the Fiscal Cliff. The House "tied" the game with its passage of the Senate Bill at 11:20 p.m. in the last moments of the "4th quarter" of the day. This contest though was to be a three-game tournament, the next two being the "cutting of spending excesses" and dealing with the raising of the debt ceiling, deferred to March via another two-month "punt of the can." Each issue will carry the reputation of the U. S. Congress for the whole world to see how decisions are made by the government that commands the greatest economy by a wide margin over any other on this Mortal Orb. It remains, though; they failed to hand in their "history paper" on time on New Year's Eve—the deadline. The title page of the Senate Bill, though, acknowledging passage of the Bill as being January 1, 2013, does insert the parentheses "(legislative date, December 30, 2012)" demonstrating the magical power of Congress to manipulate the time machine of the universe to make "today" into "two days ago" with the stroke of its pen!

Senate Crafts and Digests a Compromise, House Swallows It Whole

Of course, as an old tax lawyer—always a tax lawyer—I tackled the language of the amendments in an attempt to assess the "damage." The format of legislation is to direct the changing of one or two words in a sentence of the code, but it does not restate the sentence with the changes included to restore the context and meaning of the change for the reader. That must be done by the reader in a separate step by referencing a separate document showing the old language of the statute before amendment. One wonders how any legislator can read the language of the amendment and understand the effect of the words

as applied since there is no document before them showing the new language as written out amended. But then we suspect that they don't read that which they pass anyway, delegating that to an energetic, youthful staff of limited experience in practice.

Working with others in our Wealth Strategies Group to analyze the new provisions, though complex and yet to be seen spelled out in the final regulations and instruction worksheets detailing the actual computations, it would appear that what happened to us was “doable in the affordable sense” in terms of the increases. The compromise was not nearly as draconian as if the Bush tax cuts had been allowed to lapse and disappear altogether. What was made permanent (a good thing) were the tax rates on ordinary income, capital gains, and dividends of the Bush era to continue in place for taxable income (after itemized deductions) under specified thresholds, as first debated at \$250,000 for joint filers, as ultimately compromised at \$450,000. What is new is the introduction of a new higher rate of 39.6% on just amounts of taxable income over those thresholds, leaving the benefits of taxable income at lower rates in place. The same idea relates to the new 20% rate on dividends and capital gains only for income that is subject to the 39.6% for ordinary income, leaving in place the Bush tax cut rate of 15% for capital gains and dividends just as had been the case before for the last half a dozen years or so. Of course, for the first time ever, there is a 3.8% surtax on dividends to fund the Healthcare Affordability Act (“Obama Care”), but only for those who have adjusted gross incomes (AGI) in excess of \$250,000 (jointly); so only the top 2%ers will pay the 3.8% and then only on the lesser of: 1) the portion of taxable income that exceeds the threshold or 2) the dividend income (standing alone). This really has the effect of shifting the entire burden of the increases in taxes onto just the top 2%ers at first, but in the end effectively burdens the top 1%ers more than “a little bit” as described by President Obama after the effect of the compromise is taken into account (certainly a double-digit percentage of that cohort). This raises \$680 billion over the next 10 years (\$68B each yr.), about half of what Obama's \$1.2-1.4 trillion opening figure was and has the advantage of being made permanent (hard to change in future debates of the debt ceiling or spending cuts). Subsequently, the president is facing the next two rounds of the debate and still is looking for additional increases in taxes as part of the expense discussion debate. This sets the stage for the first quarter of the year with more of the brinkmanship which we unfortunately have grown accustomed to seeing from our elected officials. Once again, *The Economist*, leader: “America's European Moment” concluding:

“This week Mr. Obama boasted that he had fulfilled his mandate by raising taxes on the rich. In fact, by failing once again to clear up America's fundamental fiscal problem, he and Republican leaders are building Brussels on the Potomac.”

We shall see.

How Did We Fare in 2012?

We are pleased to report earnings for year-end 2012 of \$9.76 per share, nicely above our initial budget of \$9.60 per share compared with a report of last year of \$8.48 per share, or an improvement of 15%. You will recall the core operating earnings for 2011 were \$9.49 per share, a \$1.01 differential with the GAAP SEC earnings due to the unusual impact of stellar stock performance accompanying the close of the fourth quarter of 2011. For 2012, these account aberrations between Operating and SEC (GAAP) earnings were not at a material variance to one another regarding our performance, each reflecting accurately our core performance. In any event, this pace represents a return on average equity of 13.63% and a return on average assets of 1.04%, up nicely from last year's ratios. This was driven by an increase in assets of 7.2% with a strong showing for loans of a 12.9% increase led by a strong performance in consumer loans (automobiles). Because of a spike in expenses in the first quarter driven by the impact of stock price increases on the deferred compensation plans tied to the company's stock value, we were “coming from behind” in the second, third, and most of the fourth quarter on a base of early growth—a mix of Earnings Assets placed on the books in the first half which combined with a lower-than-budgeted provision expected in the fourth quarter to make for a strong positive increment of earnings performance as we crossed the finish line.

This solid performance was in the face of a roll off of maturing higher-rate assets for four years of the recovery (and Fed policy intervention expected to continue) giving up yield of 26 basis points while managing the aggressive (lowering) cost of funds by an offset of 80% of the drop in yields, but maintaining a net interest margin (NIM) essentially flat of 4.02% taxable equivalent (TE) for this year compared to 4.05% TE for 2011, well above peers. Chairman Bernanke has forecast continuing rates as they have been since 2008 until the economy signals improvement, meaning unemployment reduced to 6.5% (from 7.8% now) and inflation well behaved less than 2.5% (2.2% + for 2012) which conservatively means historically and unnaturally low “policy-driven rates” until 2015. Asset quality continues to improve as many of our troubled credits have seen an upgrade in their prospects and performance, ultimately resolving with a net charge-off of .23% for 2012 on a 13-year average of .20% (superb) which has been a key differentiator for us throughout this troubled period. Plaudits go to our credit administration and underwriting which has supported a sustained performance of quality credits, especially compared to peers during the Great Recession of 2007-2009, the recovery from which is deliberate but continuously improving. These data and trends combine as one of the secrets of community banking which set us apart from our Wall Street friends.

The Special Dividend 2012 = Acceleration of February 2013's Dividend to Dec. 27, 2012

With regard to our dividend, we paid \$1.50 per share in February 2012 and \$1.61 per share in August 2012, accumulating then \$3.11 per share for what I will call the normal and usual dividend cycle for 2012. Dividends paid in 2011 amounted to \$2.87 per share for an increase of \$.24 per share or 8.4% year-over-year to reach \$3.11, meaning the difference paid in each of February and August of respective years. Because of the failure of Congress to act responsibly to pass legislation so both consumers and businesses could plan normally and responsibly, we thought it in the shareholders' best interest to pay the dividend of \$1.63/share budgeted for February 2013 effectively five weeks early, thereby avoiding at least the 3.8% new surtax on investment income (dividends, interest, and capital gains) which was a part of “Obama Care” passed earlier in the year. In addition, there was a clear threat by the administration to let the Bush tax cuts lapse altogether. This could have significantly raised the rate on capital gains and dividends, bringing back to those in place 11 years ago which were 28% or a 13 percentage point increase. Combined, this was a potential additional tax on dividends of 16.8%. Fortunately, the New Year's Day compromise permanently enshrined the Bush tax cuts for those earners under the threshold (\$250,000 at first, then \$450,000 taxable income) except for those amounts subject to the top bracket of 39.6%, which in that case the rate on investment income would be 5% more or 20% on that portion of dividend income falling claim to the 39.6% income tax bracket. So as it turned out, the acceleration of the February 2013 dividend into the 2012 tax year did save 8.8% on dividends that were subject to the income tax top bracket. So, everybody was a winner. That said, of course, by the time you read this you will realize that you have received your February dividend for 2013 in December of 2012 and your next expected dividend would be in August of 2013 so the “proper” comparison of your 2013 dividends would be the \$1.63 which was declared and paid in December of 2012 plus the dividend declared and paid in August of 2013 to get a valid “annual” comparison year-over-year (apples to apples). Of course, the SEC (GAAP) accounting rules would show 2012 dividends including the \$1.63 combined with the \$3.11 for a total of \$4.74 or a 65.2% increase, nominally true but in intention the \$1.63 was budgeted and a part of the 2013 year for purposes of comparison. Over the two years you will get the usual four dividend payments. This response to the effects of government vacillations affecting all of our lives is a reflection of our corporate culture of consideration and caring for our constituents in the face of the government's failure to act responsibly.

Community Banks Differentiated, Dodd-Frank “Piling On,” and Common Sense

The personal **relationship** that we have with our depositors and borrowers becomes critical when special considerations need to be taken into account, especially during economic downturns. Fortunately, in each of the last five recessions, our experience has been consistently an inflow of new deposits and accounts each year which provides the opportunity for more lending and

better earnings during these downturns in contrast with the usual bank industry experience which is generally reduction in growth or net outflows.

This is due to our adherence to time-honored principles of underwriting quality loans and relationship building (more households) which really makes all the difference (an advantage over the competition) during times of travail. Community banking is special, therefore, a characteristic which is not acknowledged by Congress as it dispenses the Bills of reform like Dodd-Frank or by the regulators who are so focused on the dozen or so Mega-Bank perpetrators of mayhem in our industry, that they lose sight of the fact that over 98% of the banks (Community Banks) were not involved in creating or facilitating the subprime originations and gathering of home mortgages for securitization and meltdown for that unregulated sales-driven process which caught a highly complicit, highly leveraged world unaware with catastrophic results.

Community Banks are now defined to an increasing degree as deposit-loan intermediaries engaged in traditional banking businesses which are conducted under well-recognized, time-honored principles, and which sustain institutions such as Canandaigua National Bank/Canandaigua National Corporation which has weathered this recent storm prosperously, growing unlike the Mega-Banks. This is in part due to the fact that we have access to a reliable source of retained earnings after payment of dividends and taxes to sustain our well capitalized condition for any season. Note that Community Banks as defined by the Dallas Federal Reserve Bank are no larger than \$10 billion in assets. There are roughly 5,600 commercial banking institutions in the country of which 5,500 are Community Banks which hold less than 20% of the nation's banking assets, and nevertheless hold more than 50% of the nation's small business loans. These account for 98.6% of all commercial banks, while they hold only 12% of the industry's assets.

Contrast these figures with the nation's 12 largest banks referred to above whose assets range from \$250 billion to \$2.3 trillion. They account for .2% of the number of institutions but hold 69% of the industry's assets. As Richard Fisher, president of the Federal Reserve Bank of Dallas, said; "If the administration and Congress could agree as recently as a few weeks ago on legislation that affects 1% of taxpayers, surely it can process a solution that affects .2% of the nation's banks and is less complex and far more effective than Dodd-Frank!" We have a learned and courageous friend in Mr. Fisher.

So, "piling on" the Community Banks which were not responsible for this debacle by the very regulators that failed to identify and contain the developing crisis and enforce the existing regulations and statutes on the books is the ultimate irony of this legislative onslaught by politicians who stoop to posturing rather than properly engaging in an investigation to get to the root cause and address that as a means to fix the problem.

Had they "Googled" who in the industry performed well during the crisis, we would have popped up as an outstanding example of a bank which had already proven and tested a method of home mortgaging effective and equal to the task. Sadly, they did not, and we are left to justify the quality of our performance with the burden of proof on us, proof already contained in the files and gathered every 12 months by our examiners at the OCC. This is a process which they have engaged in over the last 35 years and holds copious amounts of hard data that proves the quality of our methodology by the preponderance of the evidence. We have found an effective solution to the conundrum which has tormented the banking industry for years that is how to finance a 30-year obligation with a fixed rate and constant payment with community deposits which exhibit a cost of funds that varies on a 3-year cycle. Certainly the Saving and Loan Association debacle of the late 1980s settled for all time the folly of any community bank placing such "traditionally structured mortgage" on its books because of the overwhelming asset/liability dilemma posed by the huge adverse interest rate risk of such magnitude that it would threaten the very viability of the bank because of the deadly mismatch which will occur from time to time when cost of current deposit funding exceeds the yields on fixed-rate mortgages on the books.

The Consumer Financial Protection Bureau (CFPB) has just released final rules (800 + pages!) for the Qualified Mortgage (QM), patterned after the identical structure which brought down the Thrift Industry and is utterly unsuited to a prudent placement

on the books of any Community Bank funded by core deposits drawn from the community. All other structures are relegated to a non-standard classification which would include all of our \$300 million mortgage portfolio, which we have built and maintained for 35 years, safely, fairly, and without a complaint or material loss—originating over an estimated 15,000 mortgages in all.

Ironically, our 3-year callable, 30-year amortization term is the most flexible product we have to offer to any creditworthy customer's situation since the loan is put on our books for the duration of the obligation. Moreover, this product offers us the highest quality, risk-adjusted reliable return of any asset we have to offer to distinguish ourselves from our biggest competitors. As such, it is the most reliable source of new capital to support future growth through the unflinchingly reliable source of retained earnings, which such homespun mortgages offer, and has been the wellspring of **all of our capital account growth** we have needed over the last 125 years of our success. This source of capital is particularly reliable and healthy in that it allows us to remain remote from the market's fragilities which plague most large financial corporations who have no other choice for incremental funding than Wall Street which has a history of seizing up at regular intervals every economic cycle. Denying the advantage of our ingenuity to solve problems of a universal nature shows the serious limitation of our regulators' capacity to solve problems, since they cannot recognize the solution placed in front of them. This administration assumes that ALL mortgages must be sold to the government-sponsored enterprises Federal Home Loan Mortgage Corp., known as Freddie Mac, or Federal National Mortgage Association known as Fannie Mae, or some other assembler, thus the debate settling on the definition of the QM. And note: Freddie (and Fannie) is a broken model of the government's design—a design which failed when it faced the reality of rates in a world economy controlled by markets not legislatures. Simply all Community Banks in the country see the home mortgage funded by core community deposits as the jewel in the crown of their loan portfolio, and if properly structured as we have shown, a prized investment NOT FOR SALE but a symbol of the relationship the bank has with the family that lives in that home from which a lifelong relationship of business can spring. What unnecessary foolishness is brewing here?

We assert our mortgage solution is free of threats of market liquidity that raises its head every downturn, since we would never want to sell these mortgage loans because we seek the secure source of reliable retained earnings which this product represents to us to support and assure the growth of our capital to support our future growth. It should be obvious that our solution does not require capital markets liquidity; that is the Achilles' heel of the QM which needs reliable markets both to fund the assembly of the assets for securitization and to fund the proceeds of sale to the end investor of the QM process. Consumers are willing to make the small adjustment to a rate defining a progressively smaller interest expense (deductible) figure because the new rate is applied to an ever amortizing (reducing) balance each month throughout the year, which is fair. At no time does this small expense pay more than the "Real" cost of the consumer's capital, nor does it ask for the receiving or giving of the implied subsidy of one party or the other to a home mortgage as market rates rise and fall each economic cycle throughout the mortgage term. Our mortgage structure represents and, most importantly, provides the assurance that our source of mortgage money (core deposits attracted or retained) never dries up, but is always available from the community. Our core deposits as a funding source are a proven, more available source of funds for home mortgage loans than from the wholesale money markets or even government sources upon which the Mega-Banks' QM securitization and sale process is unavoidably dependent.

The CFPB rules force all mortgaging to be funded and sold into public markets which in themselves present a risk certain to occur from time to time of the interruption of the availability of market money for housing finance. Reliance on Freddie and Fannie, forced into a federal conservatorship still ongoing with all the attending problems and vulnerabilities which drove Freddie and Fannie into that unenviable state, is an obvious demonstration of a broken system for which we have a solution which has worked flawlessly for 35 years and now is threatened to be discarded because what we do is different from the Mega-Bank model! Of course, that we ARE different is the key to our success. But our comment letter solicited by the regulators and explaining the business model goes unacknowledged and apparently unread. We conclude that no one in authority is listening, but more on that later.

Where Did the Big Banks Go Off the Rails?

I am often asked where the big banks went off the rails. Where is Wall Street in the mix of responsibility? The answers to these questions are grounded in a shift of priorities within the existing and competing cultures with respect to where the primary focus and subordinate should lie conflicted by competing motivations of the different business models driving the financial business units involved. Two broad categories can be immediately identified.

The first and most successful (on many levels) is a culture (like Canandaigua National Bank/Canandaigua National Corporation's) whose primary focus is on the thoughtful understanding and underwriting of the intrinsic value of traditional commercial and consumer activities, in the organic and practical sense. By intrinsic value of the business, I mean as a formatted structure for organizing a group of human activity assembled for a common undertaking that is the collaboration of human capital, physical, and financial capital for the purpose of developing, manufacturing, marketing, and distribution of an array of purposeful products and services. By engaging in this manner, we provide a living wage for the staff who works at it and the leadership which guides it; and we share with the owners (stockholders) in 30% of the profits annually as dividends (implying tangible proof of a profitable and sustainable enterprise); and we nurture the growth and value of this collaborative working corporate structure, itself growing in value by nurturing the human capital to the same degree as the financial capital for the long term. The constituents are categories of folks who have a common vital and direct interest in the enterprise, collaboration between the staff and the customer/client to include the owner-shareholders who are best because they close the loop of corporate participants, and by extension, the community at large.

The alternative approach (Wall Street's) chooses not to place the primary focus on the organic aspects which directly produce value but to primarily focus on adding value to the shareholder's ownership interest described above through differentiating the products, service, and ultimately the price of the stock by means of aggressive marketing and managing of expectations of the customer/client. This is done by appealing to the emotions and other associations thereby boosting the revenue potential and shareholder's price one would receive if part or all of the stock were sold or traded. This then often utilizes a leveraging mechanism through trading on one's own account or gaining strategic advantages by mergers and acquisitions of complementary lines of business with an eye to further enhancement of the value of the company by directly hyping the price of the stock in the eyes of markets.

Remember in terms of investment, **the share of stock in a corporation is but the first *derivative* of direct investment in the organic activity adding the value** which is the result of the corporate collaboration of the resources drawn to the purposeful activities we see as the business of the corporation.

The first is a **long-term** strategy to buy, hold, and grow the company for its intrinsic value as it grows over time whilst paying currently a dividend (share of the profits). The second alternative is a **short-term** strategy which depends on perception of value reflected in the stock price spun out by a concerted sale and marketing program to achieve market share or heightened exposure from which an apparent success is established at least temporarily. Often this is the very opportunity which the owners have been building toward just to orchestrate an exit event to convert this apparent value into real cash proceeds of sale and depart the business in search of the next deal. The first is about a long-term vision of what the "company" consisting of the four constituents noted above wants collectively to BE. The second is about a short-term goal for the company's shareholder(s) (1 of 4 constituents) and what the shareholder(s) wants to HAVE. This is a personal values issue which will play out across an array of prospective methods to quantify the point where one's "feelings" regarding the various components of the value equation triggers the call to action. This point ranges between Cost (tangible) on the left of the scale appealing to the analytic side of the brain, Price at the mid-point, and Value (intangible) on the right appealing to the emotional side. Generally, we do not "buy in on a deal" unless the value to us is greater than the price; and the price must be greater than the cost to be a real, credible, sustainable, and warrantable transaction.

Of course, most enterprises have a mix of both types of cultural influences inherent in their makeup. Consider half of the names of Fortune 500 companies change, leave, or disappear every 15 years by means of merger or acquisition, and the average tenure of the CEO is 3-6 years then retirement with a “mountain” of stock options. Consider in stark contrast that Canandaigua National Bank/Canandaigua National Corporation is celebrating 125 years under the same name, and the average tenure of the CEO is 32 years. And then there is Citigroup claiming 200 years whose stock lost 90% of its market value at the bottom in March 2009 at \$1.63/share (less than their ATM withdrawal fee!) now bouncing back and trying to repair its reputation, and Kodak at 124 years, one less than Canandaigua National Bank, is emerging from bankruptcy a mere shadow of its former self. Clearly, despite the mix of cultures, the outcomes can be widely disparate.

Certainly, the Notion of “Long-Term” Perspective is Part of the Answer

The business model to which Canandaigua National Bank/Canandaigua National Corporation has subscribed for 125 years remains in function and philosophy fundamentally unchanged and is driven by the long-term collaboration of staff and customer in pursuit of a purposeful investment to underwrite the constructive activities of businesses and consumers. We measure our success in doing so by the steady growth of the number of customer/client relationships and the sustainability of our enterprise by access to a reliable source of retained earnings to refresh and grow our capital to underwrite and support our growth in the pursuit of our mission to grow the community through its four constituents: staff and colleagues, customers/clients, shareholders (which overlap the first two categories to a significant degree), and the community.

After World War II and up to 1950, this long-term view prevailed in many traditional partnership firms engaged in investment banking in both Mega-Banks and security firms on Wall Street which adhered to a traditional measured, balanced (growth and dividend), and suitably diversified approach. **Beginning in the 1950s, though, over the next 60 years to date, there have been enormous changes, changes in kind, of how these firms and a selection of the top dozen or so Mega-Banks housed on Wall Street were structured and the nature of their businesses—from whence they derived the lion’s share of their revenues—in the beginning primarily from the stream of loan payments, but then a shift to primarily from the streams of proceeds of sales coming from trading stocks, bonds, and other financial instruments now held in their own proprietary accounts.**

This transformation was driven in significant part by a veritable revolution in technology that provided new capacity to conduct statistical analysis on everything from scientific research, to economic performance, and the ability to develop models to map and then predict the responses of markets to breaking new developments. **Added to that was the sea change in the speed and pace of communication and the inter-connectivity of the world** through the conversations among parties to the investments and especially with respect to finance and the switching from one asset class to the next with just a “mouse click” or a key stroke on the computer. **This had a drastic effect on the choice of focus, driving out consideration from the long-term considerations in exchange for the immediate “hot pace,” glamour and opportunities which the short-term perspective offered to make money by speculating on shifts in stock prices** based on shifting expectation of earnings projections in response to breaking news flashed across the market screens ubiquitously available from screen displays in the brokerage office to iPhone and ear piece. Gone were the time-honored, disciplined concentration on investment fundamentals conservatively applied for the long term, as the attention turned to and was overwhelmed by the sheer volumes of the “razzamatazz,” go-go pace, which dominated the scene with an attention-rattling focus on the daily price gyrations, a froth reacting to the marketing spins of each new event, be it financial or geo-political. **This crowding out and overwhelming of the traditional stabilizing approach introduced destabilizing potentials tied to computerized trading, shorting the market and allowing for holding periods**

of positions down to 16 seconds, then closed out to garner huge profits. The price of any established company's fortunes obviously cannot be fairly determined in just 16 seconds.

Change of the Business Structure (Form) from Partnership to Corporation

Compounding the vulnerabilities was a shift in business structure from multigenerational relationships based on fees generated for advising clients and facilitating raising capital by public offering to raising new capital as an investment banking firm structured as a partnership. At the turn of the 21st Century, the partnership structure and the personal individual liability of each partner for the liabilities of the whole inherent to partnerships were discarded by the investment banking industry in favor of refinancing the capital structure as a corporation funded by a public offering to sell shares of stock to the general investor public to provide the capital structure now backed by capital raised in the markets. **This allowed the partners to limit their personal liability by cashing out their personal assets that were the backing for the firm which was replaced by an IPO. Neat. Why not use "other people's money to leverage the firm's proprietary trading functions?"** In essence, "owners'" money was replaced by "renters'" money.

The "Net Capital Rule"—the "Over Speed Safety Value" Dismantled

With new and more capital, the top five investment banking firms then went to the SEC in 2004 to request to be released from the provisions of the restriction of the "Net Capital Rule" limiting the firm's borrowing leverage to the ratio of debt to capital of 12 to 1. The rule acted as a safety valve to limit "the steam engine from over speeding" lest it should blow up. The essence of their appeal, which the SEC bought into by issuing the waiver of the rule's restrictions, was their desire to underwrite and trade on their own accounts a new wave of sophisticated, complex instruments of securities (credit default swaps, CMOs, and other exotic derivatives) based on their computer models' predicting performance and market pricing of various combinations (supposedly internally hedged besides) to manage and spread the financial risks effectively and benefit by the new revenue streams derived by leveraging these investments. The risk created by this expanded capacity of leveraging was deemed to be hedged appropriately itself by employing sophisticated computer risk models enabling hedging with similar-type instruments to spread and off load the risk. Ultimately it worked out just in reverse, since AIG's London office cornered the market by buying up credit default swaps (CDS) and thereby consolidating the financial risk from many parts of the world rather than spreading it. So, when the financial markets faltered, AIG "blew up" spreading the disaster via the many interlinks with other major investment firms across the world.

Thus, the transformation was made complete from the Wall Street model for investment banking and its traditional role as the source of new fresh capital formation by partnerships with their personal assets at risk by floating and underwriting initial capital offerings for a limited period for a fee/discount of the first funds raised and built upon the client relationship developed, to a model with a routine characterized by a series of short-term interludes featuring a slick marketing spiel, trading for their own account a complex combination of new-styled instruments of faceless numbers of counterparty transactions processed at a frantic pace and with explosive volumes. This created a veritable tinder box in waiting of a match to spark the conflagrations made possible by the additional leverage now available which allowed leverage ratios of 40 to 1 and intra quarterly of 50 to 1, without recourse and the ability to "depart the field" with gain in the millions.

The Role of Human Nature: a Force Majeure—Markets, Commerce, Business Structure, and as Consumers

So how did we get into this state of affairs? Why is it that the monster which lurks in the shadows beneath Wall Street leaves it so fragile and vulnerable? And how could Canandaigua National Bank, as small as we are, triumph in a dysfunctional economy under stress, while the giant Wall Street firms crumble? **Another part of the answer is in the role human beings play**

in influencing the smooth functioning of groups and their internal dynamics. Systems Theory, which I have discussed in this space before, as applied here, shows the benefit of the inherent feedback loops of information which, if functioning well, will continuously be adjusting and thereby improving the effective dynamics of those participants engaged in the groupings. The confluence of elements bearing on the healthy functioning of groups and their effectiveness tended to be complex and varied but depend on many feedback loops to deliver peak performance by promoting the effective flow of information and the active participation of human beings of insight, common sense, good judgment, and shared values and purpose. When barriers develop to interrupt the coordinating influence of this observed dynamic, then the group dynamics begin to falter and the group's effectiveness is significantly impaired and becomes unresponsive altogether.

From the start, we must assert that the world of finance and banking has more to do with human beings acting like humans than the numbers (I recommend the writings of Henry Kaufman and John Bogle to you). Second, human behavior is inherently inclined NOT to be compliant with rules (be they regulations, protocols, company policy, or standard operating procedures). The behavioral psychologists tell us that we humans are at first usually inclined to do what we want, when we want, despite that such behavior may be contrary to our best interests. Third, it follows then that decision making is at first emotionally based and subsequently rationalized as presented to one's significant other at a later time with a "steely" rhetoric. Fourth, as mentioned above, how we value things is placed on a spectrum with Cost on the left, Price in the middle, and Value (choice) on the right. The left increment is number/rationale driven where the right increment is how we feel—the emotional, non-financial, art-form component of Value.

Thus, regarding human behavior in financial markets, it is no surprise that our mentor, Arthur S. Hamlin, oft asserted that he could not predict what markets (Bond or Stock) might do six months hence, be it buoyed with confidence and euphoria or consumed by fear and panic. Thus, it is settled that it is not the numbers, but human nature that precipitates and dominates market valuation and its volatilities, the "Animal Spirits" Keynes identified which I have touched on in previous writings. Certainly, John Bogle (Vanguard) and Henry Kaufman (Bond Market guru) would agree with Arthur. These gentlemen were exponents of the approach that investment is best done with the long-term view and, as we shall see, at a lower risk and higher return overall in the end.

Following these critical insights into human behavior and their material impact on markets, it is also true that generalizations may be effective in the learning process to bring understanding to the components of an issue, but as applied in the field, a generalization is NOT ALWAYS accurate for the purpose of understanding a specific application, because if human beings are involved, the circumstances will always work out to be unique, calling on common sense, good judgment, and improvisation on the theme to effectively close the undertaking. This is a huge problem for those who make a career of making rules for others to follow which is a primary function of governing bodies, be they municipal, corporate, or personal. Seldom does the rule maker consider the "reflexive non-compliant gene" embedded in the personality of every individual who may be a target for the rule. We shall see why the failure to account for these well-established distinguishing features of human behavior in the programming of computers to reliably project and predict market prices is rendered impossible because of the non-linearity of human behavior.

Technology Revolution; Impact of Computers and Instant Communications—Misapplication

Every so often in history there comes some breakthrough discovery which precipitated a revolution—the Industrial Revolution, for example. For the last 50 years it has been a technology revolution manifested by the computer chip and solid state electronics. As is the custom, there is a rush by people to jump in and see what new capacities are found. Math and Science come to the fore and clever youths found ways to apply computers to everything. In Finance, programs used to understand the propagation of heat through metal were adapted for use in valuing sophisticated financial instruments. Though some limited value was found in valuing options for stocks, bonds, and currency exchange, the same programs were not robust enough to value

futures in complex financial instruments. So the variables in the performance at the tails of the curve proved highly unreliable in the extreme with disastrous results. The people who were using the programs knew nothing of their limitations and were never intended by those that drafted the program to be applied to such complex instruments. Moreover, they were never validated in real markets (which did not exist) as in the case of options and currency exchange (which were validated by market experience). While we can understand why people thought the programs might work effectively, the fact they were not validated against market experience, which was a serious error and then to use them anyway, was foolish in the extreme. This is like the FDA not testing drugs before they are released for human consumption.

Similarly, computers were regarded as a savior of a sort because they could assist us to make sense of mountains of statistical data like the weather and help predict thunderstorms and their paths by crunching massive amounts of the scientifically gathered data, albeit described as “Mother Nature.” But when that processing potential was turned to the problem of predicting market performance driven predominately by human factors, the programs failed. Human behavioral data are not inherently constrained by the discipline of the laws of natural phenomena. This is yet another example of failure to note the impact on statistical events of human beings as differentiated by statistical events of the physical world. Yes, sadly, Mother Nature has no “feelings.” The technology accelerated the scope and pace of communication and the ability to act swiftly even worldwide enabling the switch of strategy instantly by assets or volumes.

The Importance of Personal Values on the Course Selected for Our Investment Program

This subject then hinges on our personal values (emotional) at work at many points along the way. Values are formed by those truths we gain by our upbringing and life experiences which guide our conduct, behavior, and choices **when no one is looking**. Values inform the choice of content, degree, and application of our knowledge which informs the degree, form, and manifestation of the call to leadership, and are all strategically interlinked. This linkage constantly builds our understanding and choices which together chart the course of our lives, who we are and where we end up. Are we driven primarily by what it is we want to HAVE, or primarily by what it is we want to BE? The former leans toward the tangible materials list and the latter toward the intangible philosophical list.

So, we see how miscalculations in our value choices AND understanding of the real data and connecting mechanisms can be made by the misuse of potentials we fully do not understand, leading to the list of unintended consequences we so often hear associated with legislation that wreaks havoc on our circumstances. This is often used as an excuse (unintended—meaning did not contemplate) in an attempt to absolve the rule’s sponsor (mens rea defense) of responsibility, but not to my satisfaction, for the reason that such bad legislation was based on the failure to aggressively and thoroughly gather all the relevant data, but rather, as more common, it is effective use of selective data to achieve a thinly disguised political agenda.

How Markets Have Changed Since 1950—The Shift From True Investment to Speculation

We understand that most revolutions, either obvious or insidious, contain some mechanism new to the age which triggers a significant series of changes. In this case, it is the ascendancy of the culture of science; effective use of the precise measurement and quantification, that is, use of computers and automation, has overcome the culture of the humanities of study, enlightenment, and reason. John C. Bogle, founder of Vanguard Mutual Funds, in his recent book, **Clash of the Cultures—Investment vs. Speculation** (2012) speaks of his “intention to bring to light the contrasting differences of the culture of long-term investing—the rock of the intellectual, the philosopher, and the historian—with the culture of short-term speculation—the tool of the mathematician, the technician, and the alchemist.” He then speaks of: “There is a difference—a difference in kind—between what economists describe as ‘value creating’ activities that add value to society and ‘rent seeking’ activities that subtract values from society on balance. One provides new and improved products and services, delivered through ever more efficient channels

and at prices that are more competitive, and the other simply **shifts economic claim from one set of participants to another.**” He goes on, “Think of the law: one side wins, the other loses, but the lawyers and the legal system profit, and diminish the amount of money that changes hands between the actual litigants. Government operates this way, too: before being dispensed as expenditures, tax revenues are reduced by the intermediation costs of the bureaucracy.

“The financial system is the classic example, in which investors trade with each other and one is the winner and the other the loser. But the **cost of trading creates an obvious economic drag that results for investors as a group in a net loss from trading activity.**” An apparent contradiction, he notes is: “While unit trading costs have plummeted, trading volumes have soared, and the total cost of the financial system continues to rise. Too many innovations have served Wall Street at the expense of its clients and investors.” The largest banks and investment houses on Wall Street fund most of the deals closed there, the financial capital of the world.

Relationship of the “Organic” Intrinsic Value of CNC/CNB’s and the Fair Market Price

For years in these spaces I have lamented the activities of Wall Street as being principally mindless transactions between “gypsies” trading on the exchange of pieces of paper which have very little to do with the underlying economics of the activities represented by those pieces of paper. Often people ask me, “how is the bank doing?” I respond in terms of expanding numbers of customer relationships, new depositors, and a full pipeline of loan customers and in our Wealth Strategies business, a steady growth of investment assets under management. And invariably the follow-up query is: “How is the stock doing?” This mindset revealed is understandably fed by a diet of the 6:00 o’clock news of how the stock indexes fared during the day along with the winners and losers of the sports, lottery, and “warring factions,” both foreign and domestic!

During the course of the year, only about 2-3% of the outstanding stock of our company changes hands in the several sealed-bid public auctions held during each year. We understand but do not encourage trades of about the same volume conducted on the Over-the-Counter Bulletin Board which may be viewed on the Internet, but lacks the broad market information of the organized exchange. The pricing of this very limited market unfortunately trades at a discount of about 15%, and at times occasionally as much as 30% to the average price established by the sealed-bid public auction which is administered by our Trust Department at the request of shareholders. More than 40 years ago we developed this very auction process to avoid situations where our shareholders would be taken advantage of by individuals or brokers preying on those uninformed or those too anxious for quick access to liquidity that are willing to settle for less than the fully informed fair value. All that any shareholder has to do is give our Wealth Strategies Group a call and ask for one of our Trust Investment Officers to discuss the options and timing available to our shareholders without obligation to convert stock to cash for the desired purpose.

Because of the limited turnover and activity in our stock, its price point tends to track over the years of economic cycles gradually and in relationship with the steady growth in Book Value at a 20-year mean figure of two times tangible book. The limited activity discourages speculation in our stock in stark contrast with Wall Street which is almost totally driven by speculation dominated by institutional money managers. And we are delighted. We invite investment for the long term only by individuals committed to our mission to grow the community, who are locally resident, and thereby ideally have the best access to the accurate information of our operations and opportunity to personally experience the quality of our products and services. Indeed, this amounts to a sustained relationship which will be mutually beneficial. Others need not apply.

For the most part, shareholders who place stock for sale in one of the auctions intend to convert capital to another desirable purpose such as a down payment on another investment like a house or even tuition for college to improve one’s prospects. Seldom is a sale intended to harvest just the gain solely (cash), because their intention in the first place was to share in the current earnings of the enterprise by means of the dividends of a growing concern and the accompanying appreciation of their stock holdings.

Our value proposition by an investment in our stock is to share indefinitely in roughly 30% of the earnings of the enterprise, and participate in the growth of the value of the ownership by the accumulation of capital of the institution through a steady stream of retained earnings, after dividends and taxes are paid, which are gathered from the business of intermediation of the depositor's funds with the borrower's purposeful investment ultimately leading to the growth of our region for the betterment of the entire community. This is direct investment in human activity and productivity (not another security subject to the unpredictable valuation variances in the security markets). Our bank acts as a midwife to the process which converts in real terms the GDP out of the ingenuity of human beings, working together hands-on in a constructive collaboration adding worthwhile goods and services for the greater good. Our cash flow, thereby, is principally composed of the monthly payment on 50,000 loan contracts funded by a highly diverse source of revenues, both domestic and foreign, flowing from the gainful activities of our borrowers. This depends upon people getting out of bed and being more productive than not during the course of the day before they retire at night. The effectiveness of Albany, Washington, or Wall Street, or markets in general, have nothing to do with that very human activity and industry which is the source of all commerce which builds the economy which creates the income flows and property values that provide for the citizen as well as the tax base to fund the operations of all government functions on all levels. **It is our processes which create two-thirds of the new jobs.**

Community Banks command only 12% of the bankable assets but hold well over 50% of the small business loans—NOT the Mega-Banks and NOT Wall Street. And we sustain ourselves by capital which we accumulate by our earning retained AFTER paying the shareholder his/her due and the government its due. Throughout our entire history, we have never had to rely on capital raised on Wall Street, the accessibility of which is not available for all seasons, especially at the inevitable bottom of periodic economic cycles, during which our sources of retained earnings continued to refresh and build our capital strength unabated as Wall Street floundered and lost half of its value (DOW March 6, 2009: 6,500). Our ship was sound, because the asset choices upon which our balance sheet is constructed are designed to all but eliminate the effects on our operation of the gyrations of the securities markets' impact on the value or quality of our revenue sources themselves, highly diversified from sources both domestic and foreign.

How Did a Culture of Short-Term Speculation Come to Dominate a Culture of Long-Term Investment?

One need only look at explosion of market activities and pace in recent years to understand the dramatic forces at play to identify an enormous shift in the cultures caused by the introduction of a new ethic and structure spawned by a sea change in technology and the boundless capacities of the computer. Annual trading in stocks today amounts to an average of some \$33 trillion. The new capital formation activities in the same market that is directing fresh investment capital (Public Offerings and Initial Public Offerings) as mentioned above to the highest and best use, be it business, technology, medical breakthroughs, modern plant and equipment rings in at about an average of \$250 billion. Reminding you a trillion is a thousand billion, and a billion is a thousand million, these numbers are large to be sure, but then that is what the new revolution in electronics and computers allowed us to experience. The portion which is represented by **speculation is about 99.2% of the total activities of equity markets.** Really? Yes, really!

Equally astonishing is the realization that the capital formation raising fresh new resources—*the justification for having capital markets in the first place*—accounts for just .8%! Truly the gypsies rule. How could the gypsies accurately set the price of our stock, or any stock for that matter? By definition, they are likely uninformed about our activities and mission, because I doubt they can pronounce “Canandaigua” much less spell it, a sure tip they have not read our annual reports. Another local who does not want the gypsies of Wall Street to set their price has been Bausch & Lomb and others who went private rather than be distracted by trying to manage their stock price rather than their business operations.

Another remarkable change has been turnover of volumes of stock traded. In 1950, the turnover as a ratio of market capitalization of all equities was about 15%. Fifteen years later in 1966, it was 35% which grew in 30 years to 100% in 1996. In a relatively short 10 more years in 2005, computerized trading and sophisticated puts and calls options commonly pushed the turnover rate to 150%. In the jaws of the crisis unraveling in 2008, it was 280% at its peak, only to level off in more quiet times in 2011 to 250%. Most of the trading goes on amongst and between the same core of institutional fund managers, which is certainly a zero sum game, but at a cost which is a significant drag on the individual shareholder's return on investment (ROI). Today, the large actively traded balanced mutual funds turnover is at 150%. Contrast the average of the index funds (passively managed) turnover of 7%, clearly the administrative cost of the former is more than twice the latter which in the long term (compounded) is a material drag on ROI of up to 33% to 50% favoring the index fund.

This kind of activity created a structure of the growth of management pools of mutual funds, pension, endowments, and the like, a cadre of “institutional fund managers” at banks and investment banks, certainly including the Mega-Banks on Wall Street, where **70% of the equities are now controlled (voted) by these institutional investors.** This leaves the individual investor/owner at the mercy of the mega-flows created by the biggest funds. Thus, the institutional managers acting as agent for individual shareholder are in actual control not only of the voting stock but of all aspects of “ownership” with little or no input by the individual owner of the fund shares. Of course the large corporate conglomerates whose shares are controlled by the institutional investment managers are themselves the institutional agents for the underlying companies they own. So, an owner of a mutual fund holding stock of 100 different companies—conglomerates who are a collection of 10 different subsidiaries—would represent 1,000 (100 x 10) distinctive “doer” businesses to keep track of.

This structure which has evolved has created a **double insurgence of agencies between the owner and the “doers”.** This creates the opportunity for much mischief between the institutional investor and the corporate conglomerate (a happy conspiracy) which encourages short-term thinking and a focus on the price of the stock rather than the organic activities driving value of the constituent “doers.” This can easily be a problem in the absence of strictly following the fiduciary principals long observed in the law of the agent's duty of undivided loyalty to his principal. Common Law, now codified in each state's statutes, call for the **agent to be at all times bound by a fiduciary duty to conduct the affairs of his agency in the best interest of his principal,** and in all cases certainly holding his own interest as agent subordinate thereto. The owner shareholder of a mutual fund, pension, or whatever is **three times removed from the knowledge and understanding,** even being able to identify the activity of 1,000 “organic doers,” which in theory is supposed to be the source of the true underlying value of one's mutual shares, truly a complex derivative of the direct activities of a multitude of the distinctive elements producing the “value add” conversion to net revenues and contribution to the funds' margin/value/price. Obliterated are the human systems with feedback loops to coordinate a veritable “chorus of activities” to assure a high-quality service or product which is the intended harmonic experience. **This is what we identify as the multiplier of performance due to the “turbo charging” effect of a refined collaborative culture overlaying an efficient operation.**

Feedback Loops Inherent in Human Systems Nurtured at Canandaigua National Bank/ Canandaigua National Corporation is a Competitive Advantage

The three degrees of separation of the shareholder owner from the “doers” is a key frailty of the Wall Street model, because it eradicates any semblance of the human link (and the inherent feedback loops responding in real time) which sets our company's model of quality apart since the “owner and doers” in our company overlap in the same space and time (geographically and corporately) approaching 100%. Every staff member is a participant in our Employee Stock Ownership Plan (ESOP) and thus has an ownership stake in the value of the business itself. Significantly by direct ownership of our stock, 85% of our stockholders (of whom many work at the company) live within four zip codes in our

market area and are likely to participate in one or all of our offerings as a depositor, borrower, or investment or trust client, and by that connection have bonds of experience and association with the company, a significant enhancement of the intangible value by virtue of that connection which in some cases is a perceived value which amounts to a value far beyond the financial benefits conferred. Most of our shareholders evince a mindset primarily focused on the long-term view of the holding and sharing in 30% of the earnings in the form of a dividend and backed by the satisfaction that the intrinsic value of the ownership is likely to increase in value. This combination caused one of our shareholders to describe our stock as his “bond-stock,” meaning an assured income (indexed) with a probability of capital/market appreciation to boot, a balanced investment fitting for any well-diversified portfolio.

Canandaigua National Bank/Canandaigua National Corporation— a Complete Investment Program in One Security

Now, the share of equity that the stock certificate represents is itself the first derivative of the activities of the issuing corporation. Thus, its intrinsic value springs from the constructive collaboration between the staff of the company and its customers. For years, I have been talking about ownership of our company stock as being a derivative of the activity of the company which is broken into a broad range of financial activities of **direct lending** to commercial enterprises and consumers combined with managing financial assets for the benefit of our customers as well as a bond portfolio of the bank representing 20% of its assets managed primarily for its liquidity at a reasonable yield.

The borrowers as multiple groups represent a **broad diversity of business activities** and markets served and whose loans are **serviced and covered by revenues drawn from an equally diverse array of distinctive sources both domestic and foreign**, representing a highly reliable cash flow each month from nearly 50,000 contracts. This flows remotely from the risk of securities markets and dependent only upon people getting out of bed every morning and being more productive than not before retiring for the evening and thanking us with a “payment” each month.

It is worth emphasizing the investment portfolio of primarily municipal bonds (tax exempt) of our bank is primarily for the liquidity and not for its earnings, a mistake that many banks make by seeking an incremental return by “reach out” by trading their marketable assets which introduces a risk of market exposure which is contrary to their primary function which is to safely provide liquidity. Our primary purpose is as an intermediary between depositors and borrowers sustaining our operations by relying on cash flow from the monthly payments from that loan portfolio rather than proceeds of sale and gain from the investment portfolio. We do not trade on our own account as an income strategy. Investment bankers did, and banks with investment banking operations did that, and they suffered punishing losses as all markets declined by 50% during the financial crisis and Recession of 2007-2009. We did not engage in such activity. Rather we charted the same course as in previous recessions since the early 1970s which in each case: our deposits went up, our assets available to lend went up, our loans went up, and our earnings went up—especially so in this last recession. **This performance coupled with an asset quality second to none propelled us into the top 20 performers in the country as I have mentioned before based on the rolling three-year average of return on equity** throughout the recession. This was out of all publicly filing banks of which there are about 1,100 in the country, notwithstanding that we are not traded on any recognized exchange.

The Wellington Fund—a Case Study of the Merits of Long-Term Balanced Investments of All Kinds— Direct Bank Loan and Securities—An Object Lesson

Though it is not commonly connected in the minds of the public, lending money to a company and investing in stock of a company **are both “investing” in the enterprise with loss exposure should the company fail**. We generally take collateral as security for most loans we make. We are seen as the secured lender to have a priority with respect to the assets

subject to the security interest (such as a mortgage) to recover the loan proceeds from converting such collateral to cash to be applied to the amounts owing, if the venture should fail. Actually what generally happens is for each dollar of equity put at risk by the owner/borrower, we will lend him three dollars which now gives him a “four dollar” enterprise of which one is his equity contribution and the bank’s three dollar loan backed by collateral. **So, generally the bank has more money in the venture than the owner** which “leverages” the owner’s dollar—which is the “American Way.” In the rare case that our borrower fails, we on average recover from the sale of the **collateral between 25-30% of the loan balance net of expenses** of “fire sale” plus a year of taxes of all kinds and fees from lawyers, auctioneers, and the like. We do not make money on foreclosures! That is why we work hard to underwrite properly up front and as a Community Bank work with our troubled debtors to the limits of the situation. **So, the story of the Wellington Fund we offer as an example as to why the only responsible way to invest in any enterprise is as guided by the time-honored principles applied over the long term; a balanced, conservative approach with the nature of human beings at the forefront of the program factors is the ONLY course to follow. This approach is as apt to and instructive of bank lending directly to the “doers” as well as to investments in securities directly or in funds managed by institutional managers.**

From the perspective of 60 years in the investment business on Wall Street, Mr. Bogle in his book tells us of the story of The Wellington Fund and how it started as an exponent of a long-term perspective, principled-driven investing, strayed for 10 years into the treachery of speculating in a go-go era, and took a beating in the doldrums of the early 1970s but recovered by getting back to the basics to return as the prodigal son to a sustained success today and better off for it—an object lesson for us all.

The Wellington Fund was created in 1928, the brainchild of Walter Morgan, Princeton 1920, an accountant turned investment advisor and tax consultant who came upon the idea that rather than manage a large number of individual investment accounts for individuals who shared similar investment goals, he would consolidate these holdings into a single investment account managed in the whole and separate out the accounting and distributions administration on an individual basis. Later, this fund became a centerpiece and part of the Vanguard stable of funds which had as its focus a traditional culture of long-term investment which was a balanced fund (growth plus dividends) and used as a marketing tag line, “A Complete Investment Program in One Security.”

Gosh, that seems to me an apt description of the shareholder experience of Canandaigua National Bank’s/Canandaigua National Corporation’s holding of direct investments properly allocated and diversified (as well as revenues therefrom), underwriting a collaborative enterprise which melds human capital and physical/financial capital, facilitating and creating 75% of the growth of the GDP by harnessing the genius of human ingenuity!

The Wellington Fund was basically a 60% equity, 40% fixed income allocation which hearkens back to the core model which Arthur S. Hamlin focused on during the same half-century from the mid-30s to the mid-80s: **Sound Balance Sheet and Profit and Loss a going concern, purposeful/useful products and services, with reasonable prospects of growth, executed and guided by a quality staff and progressive management.**

For a brief 10 years from the mid-60s, the Wellington Fund management gave way to the spell of a new culture of speculation reflected in the go-go years of the stock market. Acknowledging this as a foolish change on his part, John Bogle as its manager argued to get back to basics, but not before the overheated market collapsed after its peak in 1972 into the market crash of 1973-74. During that period, the Wellington Fund’s assets under that regime shriveled to about 25% of its mid-60s’ value. Having “righted the ship” by 1978 and going “back to the future” of the conservative long-term balanced view, the Wellington Fund today exists as a pinnacle of success of the balanced, long-term view subject only to concerns about asset allocation and diversification principles.

Hard-Learned Lessons of the Ages, No Exceptions—Period!

In the end, John Bogle and Arthur Hamlin came to the understanding that the total return of the truly indexed balanced fund outperforms over the decades for the individual shareholder, a similar investment in the actively managed fund (turning over 150%)

because of the negative compounding effect of the administrative expenses and the high turnover. Thus, the settled data support the uniform counsel for every investor, individual or corporate, to employ a disciplined process of thoughtful engagement, long term and in a balanced way between growth and current dividend, and patiently ride the growth and current dividend which springs from the intrinsic value of the enterprise's collaboration of human capital and physical/financial capital.

This has been our approach to managing Canandaigua National Bank/Canandaigua National Corporation as a business for growth in harmony managing the growth of revenues and retained earnings to infuse our capital base sufficiently to support appropriate, controlled growth to support our long-term viability to serve our community in all economic seasons. This we have done consistently throughout our 125-year history. Ours is a business that prospers if it is grown at a thoughtful pace, managed to maintain an effective balance to “stay in the curve,” which is nominally an 8% growth rate as a rolling average annually over the trailing decade, the measure of a typical economic cycle, plus or minus, which has resulted in doubling the common equity capital of our company every eight or nine years after dividend distributions over the same period. Importantly, this course was hugely resilient, especially during troubled times of the last five years of the Great Recession.

Thus, this story is just one of many that vindicate the investment philosophy which has borne out over the 60 years of John Bogle's and Uncle Arthur's careers as consistently delivering the best combination of growth and current dividends. This is a perfect description of our own Canandaigua National Bank/Canandaigua National Corporation stock as a “bond stock,” meaning an assured dividend with a probability of growth of principal value which has a place in any well-managed portfolio—“a complete investment program in a single stock.”

Thus I recap the fundamental principles of the Wellington Fund story, which reinforces the universality of the Canandaigua National Bank/Canandaigua National Corporation's story to our shareholders and all investment managers that are given to opine about our stock to the same point to “Buy Right and Hold on Tight.” The performance of our stock over time tends to raise the scepter to rebalance or lighten up on Canandaigua National Bank/Canandaigua National Corporation which has brought imbalance to a portfolio. To replace our stock with some alternative on the New York Stock Exchange exposes the portfolio to an increased risk of volatility caused by the nature of the market populated 70% by institutional managers prone to speculate among each other. This is a personal choice, and each person has their own measure of risk tolerance or comfort. But a decision to continue to hold Canandaigua National Bank/Canandaigua National Corporation stock is continued access to direct investment in human activity at the heart of the value-added process, which is the mechanism underpinning the potential of growth embedded in the intrinsic value of the purposeful collaboration of a viable business constructive to sustaining the quality life of a community to carry the day to a successful conclusion.

A Dynamic Strategy for the Future Built Upon a Proven Dynamic Success of 125 Years— Ever Alert to What Changes, But Also the Human Nature That Does Not

In many regards, we present through the ownership of our stock direct investment in a perfectly diversified portfolio of loans, mortgages, and investments which does not require a functioning stock market for liquidity or the sale of anything to garner a return that makes its way to retained earnings and capital which is what is left of the cash flow from monthly payments of loan contracts after the payment of taxes and dividends. These retained earnings are a fountain of reliable additional capital to underpin controlled future growth indefinitely (now evident for 125 years).

Note that financial markets that consume the attention of Wall Street are not necessary or relevant to the effectiveness of this earnings process. Our process stands on the concerted activities of individuals going about their daily lives. The assurance of the functioning of this model lies in the businesses and activities of our borrowers, both consumers and commercial enterprises, which are fed by an almost infinite variety of revenues earned as wages or as income from those commercial enterprises, both domestic and foreign, funded by a core deposit base drawn from a historically dynamic upstate region that is largely interest rate

insensitive, even more so in bad times. It has been the sole but demonstrated experience of this institution to enjoy an increase in deposit inflows as financial circumstances get more perilous as indicated at the close of 2009 in the darkest hour of the recession (Dow cratered March 6, 2009 to 6,500) where the consumer deposits over a two-year period ending December 2009 increased 38%. This deposit performance could not be explained by the 10 basis points that we were paying at that moment but only because of the **utility value** of the cash in the bank which is seen as a comfortable tie and which connects the payables and receivables both of the household and the business in the nature of a utility so the accountholder could pay for their utilities in the form of water, gas for heat, and electricity for light—all making **the assured available cash balances in the Canandaigua National Bank the ultimate “utility” of utilities.**

Our greatest strength is our positioning as a matter of balance sheet choices to invest in assets which are as **far removed from the frenzied markets of the activities of the gypsy speculators on Wall Street** as can be gotten and still remain on earth. The secret of the stability and sustainability of our brand of the community bank business model is at once the predominance of our direct investment in human enterprise which resides on our balance sheet as a dynamic asset (not sold), and the remoteness of our processes from the volatility and purposeless folly of markets consumed by speculation, rather than purposeful long-term underwriting of constructive human enterprise.

Wall Street is dominated by professional managers which hold 70% of the equities. The shareholders of the mutual funds or members of the pension plans have little or nothing to say about voting the proxy, understanding the activities, quality of management, the balance sheet, the earnings statement, and prospects, because they are so far removed. As a result, the primary influences are a directive to short-term events, optimistic projections, and mergers and acquisitions, all with a focus and marketing of the stocks as a means to create shareholder value, which is in reality a short-term focus of a moment's emotions driven by marketing and popular opinion. In this view, there is no acknowledgment of the efficacy of the long-term, solid reality/data-driven intrinsic value of the corporation and its collaboration of staff and customer creating real value, real goods and services, and dynamic growth. The interlocking of both sets of agents, those representing the mutual fund and those representing the conglomerate, align to focus on the expectations of the market rather than the intrinsic value of the corporation in the real market.

Interestingly enough, the **institutionalization of equity ownership** was just 8% in the 1950s, 18% in the 1960s, reaching 50% to 55% from 1985-1995, 65% pre-Great Recession, and to 70% to date. The problem is that these powerful new institutional agents act less like owners of stock than renters as they turn their portfolios over with abandon, trading largely with one another engaging in clearly a zero sum game that only enriches Wall Street intermediaries and ill serves the principal, the classic shareholder/owner. **The average holding period for a stock in a mutual fund portfolio in 1950 was six years and in 2011 it was one year! What cost is the “drag of the administration of this churning?”**

So at the root of “why the banks ran off the rails” was the separating and isolating of the ownership by three steps removed from the organic business activity, leaving the classic shareholder with the only measure of value of his holding being the **price** of the stock every 90 days as compared with the value of the organic activity which produced the value intrinsic to the corporate collaboration between staff and client every 90 days. Also distinctive is the **importance of the value to the participant worker of the “joy” of that association and of the opportunity of doing worthwhile work with worthwhile people in a supportive culture which is as enfranchising as it is stimulating**, itself a stable, self-fulfilling influence of a complex human system with multiple feedback loops which is the essence of its sustainability and strength, and adaptability. Ten years ago, the oft cited credo of the purpose of a business organization, at least piped from an MBA curriculum, was to **“enhance shareholder value.” As we have observed here many times, this call to arms generally leads to the short-term selling out at the first attractive opportunity price, with the sad result of discarding the human equity built up in creating the apparent value, much to the dismay of staff, customers, and community.**

Wrong answer!

Our entire business model is based upon time-honored principles of banking and finance, the success of which is more about serving the needs of human nature than it is being a slave to the numbers. It is academic that values must exceed price/cost for anyone to “buy in.” Cost and price can be measured by number but value is essentially an emotional index. We have long understood that banking is more about human nature than it is about the numbers as far as peoples’ behavior is concerned.

Thus, all of our policies, procedures, and guidance to mold the behavior of our staff and clients keep top of mind that we are dealing with human beings. The big banks suffered by their shift of focus from long-term conservative to short-term market driven and in so doing valued the financial aspects, just as the isolated shareholder, rather than pay attention to the intrinsic value. We focused on the power and creativity of the corporate collaboration of staff and customer which is an organic, dynamic human conversation which builds relationships of intrinsic value far more valuable than the moneyed transactions no matter what the volumes may be. This is the disconnect; this is where the Mega-Banks left the tracks; their only reality was performance measured by the price of their stock, moment by moment, driving short-term thinking.

Culture as the Multiplier Which Boosts Performance to the Stars

Culture begins with a shared set of values and in the company of knowledge generally leads to leadership and performance, but knowledge and leadership without values is an accident waiting to happen. It is principles and shared values that propel organizations, not any individual. The concept of stewardship implies a fiduciary responsibility and the realization that every private action has a public impact and that our purpose, be it political or financial, is for the greater good and not for our selfish purposes. The shared values then are the guides for our behavior in a common enterprise when no one is looking. In combination, this is a culture which is purposeful, collaborative, and constructive—and what drives real value generation.

Taken together, this approach to these collaborative activities is a multiplier of a sort which applied to a good serviceable plan returns not just very good or excellent but continued “celestial” performance.

The business plan of the last 25 years, specifically the last decade or so, was a solid strategy to expand our notion of financial services for individuals, be they growing families or businesses, into a larger population base of the Rochester metropolitan area. Any reasonable collection of people could have been successful if they stayed focused on the Plan for Value 2010.

But we tripled the size of the assets and quadrupled the earnings. We began by rallying around these core values which are central to how we lead our lives: honesty and integrity, responsibility, teamwork, respect, innovation, professionalism, and commitment. The Plan for Value 2010, driven by a culture based on these values, produced consistent record performances in the 125-year history of the bank, but most importantly in the worst, most trying times of the greatest recession in living memory since the Great Depression. The guiding principles focused always on the long term, a solid balance sheet, reasonable earnings, and attractive products and services committed to underwriting the growth of the community guided by a strategy to invest as much into attracting and developing our own people as in our plant and equipment. And the people delivered on their collective potential to achieve: First in Show! The secret to our future prospects is to adhere to these principles and to invest in the development of our people who possess and live by these core values and thereby nurture the culture which when applied boosts the performance and sustainability of the company. If we do these things, we will not fall off the rails as our bigger brothers did, and as others will do in the future, for being beguiled by false prophets and all that glitters.

Final Reflections—Stewardship, Duty, and Bright Prospects

So as I close these reflections on the year 2012, and 10 or 15 years, indeed even 125 years, we understand the purpose of this wonderful enterprise is its sustainability and fiduciary duty and good stewardship with respect to not just one of our constituents but all four of them. We conduct this stewardship by balancing their interests in a dynamic fashion which depends on us nurturing the human capital as much, if not more, than the financial capital. We acknowledge this as a dynamic business involving human

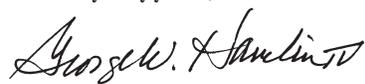
nature in the extreme and that adding value to that which resonates with that nature and builds relationships is the key to our future. With respect to governmental influence in our processes, it is sad that the government is not aware of, nor measures, the effectiveness of its voluminous rules to its stated purposes of safety and soundness, consumer protections, or building the economy. The government does not acknowledge us as a part of the social DNA as we are as being a midwife in the process of human ingenuity which constitutes 75% of the growth of the GDP. As we sense government interfering in this process, we have a duty to give it the respect that it deserves, but to push back, educate, and refocus Congress, regulators, and state legislatures to look at the real data, because by definition, they have a limited capacity to fix that of which they know very little. My grandfather, George W. Hamlin, in the 1930s had to do the same in an equally, if not more troubled time, so we accept this as our task, responsibility, and the way of the world.

Notwithstanding these incursions by an avalanche of new rules and regulations, our prospects remain bright in view of our financial strength, our marketplace, and prospects, not to mention the quality of our staff and the buoyancy of our culture to face any challenge and respond dynamically and adroitly to find a solution as we have done for a century and a quarter. This year was a perfect example of how we were able to prosper and grow in our mission and reputation in spite of the dysfunctionality and disappointing machinations of our Congress, legislatures, and regulators.

I refer you to Frank's President's Letter which will get into the detail of our program and other activities during the course of the year which set the stage for our success in the future, and in spite of these rough patches which I have described in some detail so that you will know the enormity of the intrusion by a government fanned by a political world driven by posturing and paralysis faced with an angry constituency who were mystified on how this could be happening. This is a sentiment to which we are sympathetic because we, too, are in dismay that the regulators and legislature allowed this to happen to our customers and, by extension, to us. We are doubly dismayed that the Congress and regulators fail to see and acknowledge the patently successful and effective business model and the products and services and the choices that we have made with our balance sheet and the businesses that we wish to pursue. They also fail to see that our choices have been correct in combating the challenges of a recession for which we did not have any responsibility but which was facilitated by our larger brothers in the Mega-Bank and investment banking world who lost sight of their proper roles. We continue to hold sacred our business model which has proved our shield against most of the economic impacts of this recession, leaving us strong and fit to help others who were suffering.

As I close, I am confident in our staff, our customers, our market, and our prospects, and by extension, our future which is in the good hands of a spirited and talented crowd of staff, customers, and clients. I look forward to a vigilant oversight as Chairman and Officer and Senior Policy Advisor to our enterprise specifically to continue nurturing our culture and the fulfillment of our mission to grow the community. It has been a privilege to guide this process over the 35 years since joining on March 6, 1978, this amazing association of such a talented crew and fascinating variety of customers and clients. I look forward to stepping back, but not entirely away, and transferring the responsibility of the continued stewardship of this organization, its ideas, and its talented staff to the Executive Team as coordinated and lead by our President and now CEO Frank H. Hamlin, III, effective directly after the close of the quarter, March 31, 2013. I remain eternally grateful for the privilege to serve you all: shareholders, staff, customers/clients, and the community as a whole.

Very truly yours,

A handwritten signature in black ink that reads "George W. Hamlin, IV". The signature is written in a cursive, flowing style.

George W. Hamlin, IV
Chairman and CEO

January 21, 2013

A message from
Frank H. Hamlin, III,
President



To Our Shareholders:

Once again, I have the honor of writing about our organization with a tone of bragging about our success over this past year. This is in spite of the shadows cast by a slowly recovering economy, and an extremely dysfunctional political environment which, among other things, has led to a tremendously burdensome regulatory environment. We have demonstrated the ability to remain agile and responsive to those barriers placed in our path, all the while continuing to provide for the needs of our constituencies.

The year 2012 presented us with another year of anticipated slow growth and ever compressing margins due to an anemic economic recovery. It was and continues to be predicted that interest rates will be artificially held low through 2015 by the Federal Reserve in order to foster an economic environment conducive to continued recovery. Since last year, however, the Fed has given us a little more insight as to when it might move rates through reference to the unemployment and inflation indexes. All said and done, it is evident from an economic perspective that 2013 will be much the same as 2012, with economic factors continuing to pressure net interest income downward.

From a competition standpoint, we continued to be the beneficiary of strategies of our competitors. Most notably, HSBC Bank made a strategic decision to leave Western New York for what it perceived to be greener pastures. As you may know, HSBC was required by the Department of Justice and banking regulators to meet guidelines limiting the concentration of deposits in a market, and as a result sold approximately 125 branch locations to First Niagara Bank, N.A., Community Bank, N.A., and Five Star Bank. HSBC at the time had more than 20% of the greater Rochester market share and as a result of its decision, its customer relationships were disturbed, thus putting those individuals into play to establish a new relationship with an organization that sticks around through thick and thin. Through the extraordinary efforts of our people, we were able to break records with respect to the number of account openings last year, thus taking advantage of a relatively unpredictable yet fortuitous market upset. We continue to see benefits from the HSBC exit, yet expect the rate of account acquisition to wane in the year to come.

From a commercial and consumer lending standpoint, we also did exceptionally well. That being said, as margins compress, we have begun seeing extraordinarily low rates and a loosening of terms and conditions being offered by our competitors as they attempt to maintain or grow revenue by putting a greater volume of loans on the books. Although the goal of increasing loan volume is noble, doing so while loosening credit underwriting standards is simply dangerous. History has shown us over and over that within reason you can lower the interest rate charged, yet lowering underwriting standards in order to “get the deal” has disastrous results. We are increasingly seeing other lenders extending loans with terms that require unusually low-value collateral or are simply non-recourse and/or for extended durations and rates which will virtually ensure their cost of funds will (if not already) outstrip the income derived from the same. We will continue to maintain our credit underwriting standards, all the while keeping close watch on our asset versus liability management. Bad loans take down banks; we will see in the next few years how the others in our market “profit” from their decisions. Long-term decision making is an inherent advantage attributable to an institution that is owned by those within the community it serves. We are not handcuffed by the needs of short-term profit at the expense of long-term common sense. It’s okay to let a deal get away; there will generally be another that will follow, especially when the focus of the interaction is the relationship, not the transaction.

In light of the strains put on interest income placed upon the banking industry as a whole, we very intentionally look for ways to not only increase efficiencies, we also seek ways to increase non-interest income. It bears mentioning that our non-interest

income to total revenue ratio is twice as good as those within our peer group. The typical Community Bank derives only 15% of its revenues from non-interest income, whereas we are at approximately 30%. This alternative source of income provides us with a safety net not equaled by our peers. We have, and are continuing to focus on, strategies to increase non-interest income by utilizing our Trust powers in ways we had not focused on in the past. Through the acquisition of OBS Holdings, Inc., which serves to protect our conduit for Dimensional Fund Advisors portfolios, we have uncovered a unique and unattended market niche within the community banking space. I remind you that there are approximately 7,000 Community Banks nationwide, the majority of which do not have Trust powers. The ability for most of those within the community bank space to acquire Trust powers is extremely limited due to the incredibly long sales cycle involved with Trust products. In addition, there are onerous regulations which serve as a barrier to entry into the market space, creating an ironic twist that regulation might actually help Canandaigua National. Through the combination of Trust powers, regulation, and OBS, we appear to have a cost-effective manner through which other Community Banks will be able to private label investment products, such as individual investments and 401k products. They will no longer have to give this business (and revenue) away to broker/dealers and their affiliated investment managers. This is a more efficient model because through the Trust power conduit, the licensure costs and requirements of the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC) are alleviated (a requirement for broker/dealers and Registered Investment Advisors). In short, this will allow the typical consumer to participate in sound financial investments without the cost-prohibitive investment management fees associated with the typical investment manager who is incented to “fee” away any portfolio growth through short-term investment strategies directly at odds with the interests of their clients. In 2013, we will continue to develop this idea as well as others closely related to it.

In 2012, through a collaboration of the retail and commercial lending areas, we instituted a small business unit. Although Community Banks like ourselves hold only 12% of the industry’s assets (the other 88% controlled 19% by Big Banks of \$10 billion to \$250 billion in assets and 69% by Mega Banks of \$250 billion to \$2.3 trillion in assets), we provide 50% of the loans to small businesses in the United States. Although the politicians pay lip service to the fact that small business creation and growth is going to pull us through this economic recovery, they continue to dump reams of new regulation on Community Banks with little regard to the fact that this will drive more and more Community Banks out of business. The real effect of this regulation is to limit the ability for small business to obtain credit and thus to grow. That being said, we recognized that small businesses are basically just large consumers in terms of loan and deposit balances. However, the small business owner is particularly situated to benefit from education and advice which we already provide, yet which can be more specifically tailored based upon industry segment.

In 2012, we trained our business development officers as well as our branch managers in the nature of small business dynamics in order to enhance our ability to provide this market segment with products and services which they will find both necessary and beneficial. This is yet another powerful way to establish trusted relationships through education and advice. Our ability to assist with ideas surrounding cash management, payroll, retirement, insurance, and other topics allows us to further differentiate ourselves from those around us. This unit is up and running and already bearing fruit both from an interest and non-interest income perspective.

On another topic, it has long been observed that our unusual culture has played an active role in our success. Thus, bi-annually we conduct a corporate-wide culture survey. The purpose of the survey is to understand how we are doing in terms of our work environment and to highlight where we might focus for improvement. Although the survey results always tend to come in well above those of our peers, the results present us with areas to work on. If the garden is not constantly tended to, then the weeds take over and ultimately choke the fruits of our labor. An issue raised through our culture survey focused on our compensation and titling system. The concern was that it is not “transparent” or, at the very least, is not well-understood. As with any system of people, there can arise a feeling of internal and external inequity. In addition, it is very common for headhunters and others to contact our employees in attempt to lure them to other institutions. We have continuously acknowledged a need to

stay aware of the “market” for talent for functions within our institution and to adjust accordingly. We had already embarked on a compensation system review through an outside consultant, with our intention to be completed in 2012. Thus, it followed that we could use the opportunity to clarify and communicate how our wage system is administered. Of course, the compensation review was also intended to ensure our compensation system is in accord with the Department of Labor mandates, such as the requirements relating to salaried versus hourly paid functions.

I am happy to say that although the process was very informative and serves as a wonderful foundation from which to communicate how the system works, overall the system as it existed was working. Almost without exception, as compared both internally and externally, the wages being paid were in tune with what the market analysis demonstrated.

The process started by identifying the various functions performed by a particular position. Once the functions were identified, they were applied against a weighted compensable point system based upon requisite skill, effort, responsibility, required education or experience, work environment, and supervisory responsibility. The summation of the points attributed to a particular job description was what was used to determine the pay grade attributable to that job description. The job descriptions were then compared against peer data to determine the rational basis for the pay grade segmentation. It is important to note that a concerted discipline was instituted in looking only at the job descriptions and not the individuals associated with those positions in order to ensure an intellectually honest compensation system. This was important to eviscerate the indicia of bias, discrimination, and favoritism.

The overriding goal of any compensation system should be to fairly align the compensation of individuals with the value of what they contribute to the organization. Certainly there are situations where employers are not in a position financially, due to external market conditions or internal difficulties, to “fairly compensate” for the value being provided by the employee. We are not in that position, which in this economic environment is the exception, not the rule. I feel that our people both acknowledge and appreciate this fact and consider it as yet another basis to believe that this is a fantastic organization to be a part of.

Once again, the purpose of this system is to fairly compensate each individual. What is dynamic about our system in particular is that it allows, and in fact incents, the individual to grow regardless of title. It is not the title by which an individual is compensated. It is the function by which compensation is derived. To the extent an individual takes on additional duties or functions, he or she changes the point factor analysis associated with the position, and thus the compensable value to the organization as a whole. Thus, going forward, there will be an effort to focus on “functional” titles that describe what an individual actually does instead of historic or hierarchical titling which is the predominant mindset of this industry in particular. We believe functional titles are a more effective way to organize the organization rather than generic titles, with their multiple layers of vice president, which in no way indicate what an individual is responsible for. Moreover, reliance upon such a titling system stymies collaboration through the inadvertent (or more likely the intentional) creation of a caste system. To the extent we can encourage those within the organization to identify and collaborate with those who are specialists in the subject matter being sought regardless of “rank,” the more versatile and flexible we will be as an organization. I fully acknowledge this goal to be similar to that of seeking justice; it will only occasionally be obtained yet should always be sought.

Continuing on the theme above, there has been an ongoing emphasis in creating a robust training program through our Human Resources Department. As our institution has grown, this need has become more important, especially in light of the rapid change in technology and regulations. The intention is to provide our team with practical skills to perform the various functions of the organization and also to continue existing educational initiatives surrounding management, leadership, and personal development. We have enlisted the help of McArdle Ramerman, a company based in Rochester, to assist us in the process. The program has been designed in order to coordinate with our Corporate Culture Survey, 360/270 Reviews, and Personality Index®, in an effort to provide insight and a method to measure progress both from an individual and organizational standpoint. Participants will be selected from all areas of the corporation and thus have an added benefit of cross-pollination

between those who do not interact with one another on a daily basis.

Another subject of important consideration is our technology. Technology is a constantly changing opportunity both from a consumer perspective as well as internal productivity. We are currently increasing the use of cash recyclers within the branch system, which has the benefit of speeding up the accuracy and speed of transactions at the teller line. This also provides an opportunity for better cash management within the branch, thereby eliminating the amount of physical cash sitting idle in the vaults of our various branch locations. We are currently evaluating the use of machines behind the teller lines which will be able to read checks, thereby reducing the back office requirement to individually process batches of paper checks. Workflows are being developed, most notably in the Mortgage Company, in order to reduce the amount of paper being used and shuffled around (which you might imagine is enormous).

From a customer point of view, we have spent 2012 fine-tuning our online experience; 2013 will bring the introduction of CNBudget Central which will be located on the left-hand side of the screen after logging in to the customer's online banking page. Through collaboration with Yodlee, this feature allows the user to aggregate his or her accounts, regardless of what financial institution the account is located with, in order to give the user a complete picture of their finances. This includes loans, deposit accounts, investments, and credit card accounts. Analysis and budgeting tools are also included.

Also, just around the corner is remote deposit capture for consumers. This is the ability through a smartphone to take a picture of a check and send it to the bank to be deposited. This is a clear benefit for those who are away on business, at school, "snowbirding," or simply not predisposed to make a trip to the bank or ATM for a single check deposit. Technology was once seen as an advantage held only by the biggest banks. Now it is clear that technology is an equalizer. This technology puts us on par to compete with the big banks that have a branch in every location across the US and the world. This uses similar technology as commercial remote deposit capture which we currently offer to business customers.

Behind all of what we do is our data repository. In actuality, our data is held in a number of databases. Each program used by the bank utilizes its own database as designed by its vendor. The data is stored in tables within its database. The problem lies in that the information such as a client address in vendor database "A" is not in the same location within the database tables as found in vendor database "B" and/or in our core transactional database, and it may have different attributes and formatting. The amalgamation of this information is important in order to obtain a total picture of our client base. This information can assist in the development of a customer management dashboard which will assist the customer-facing employee in understanding the client's total financial relationship with the bank. In addition, this aggregation of data will enhance our ability to analyze customer behavior for both enhanced security and customer-specific product and service recommendations.

The initial basis for our relationship with our current core data provider was the understanding that it could serve as a central repository for all information collected through the various programs we utilize. This has proven more challenging than theoretically proposed. We are currently evaluating various options to warehouse all of our data in one database. This is expected to be a time-intensive exercise, yet the benefits unleashed by being able to analyze all the information which we accumulate from all of our processes every day will be magnificent.

As our 125th year comes to a close, as well as my second year as President of Canandaigua National, it is abundantly apparent that one of our key differentiating attributes as an organization is our willingness to learn and innovate. We take the opportunity to see how we can do things; provide products or services in order to find solutions for situations which don't fit the norm; in doing so, we have earned the reputation and the brand which stands for high-quality service and intellect. Although efficiencies are important, the willingness to spend the extra time to work with the unusual situation is what garners loyalty with our client base. The story of that extra effort and ingenuity gets told over and over again.

This differentiation is critical because it cannot be easily duplicated. It is the result of a mindset within our culture. Legal and regulatory factors acting in concert with a constant focus on earnings and efficiency push relentlessly against taking the initiative

to structure solutions for individual clients in new and unique ways. It's not "cost effective;" yet it is this initiative which attracts and retains our client base.

Without question, our industry is faced with a crush of new and poorly thought-out regulation. Those who create the regulation are tasked with addressing specific perceived evils, yet lack the ability or authority to take into account the numerous consequences of their conduct. There does not exist the intellectual honesty to evaluate the true sources of disruption within our financial system responsible for the severity of this most recent financial cycle. Instead, the focus has been on the politically convenient catch phrase of "consumer protection." This is the functional equivalent of putting lotion on a rash instead of addressing the underlying allergy. The rash may not itch as much, but it keeps coming back, often worse than before. Freddie Mac and Fannie Mae are circling the drain due to the fact that they hold 90% of the 30-year fixed mortgage debt. Even assuming that the loans within those entities' portfolios don't default, the holding of that debt is still a losing proposition due to the extremely low interest rates associated with those loans. I recently heard at a New York Banking Association Economic Forum dinner that there are bankers who do not believe that poor interest rate risk management can bring down a bank, or for that matter a financial system; this is very alarming. Ultimately, we the tax payers are going to pay for the losses of Freddie and Fannie. Even as this letter is being written, those same players who created the last financial debacle are looking for another non-recourse, government-guaranteed receptacle to which they can sell their garbage. In short, it is no accident that the SEC is extremely underfunded and understaffed. Watch what happens to Freddie and Fannie, and pay attention to what happens to their assets and what replaces their role within our financial system.

With the above being said, we believe that the onslaught of regulation, although the death-knell for many Community Banks at large, is an opportunity for us. We have an extraordinary legal compliance group which will enable us to provide service to our customers despite what the federal and state governments throw at us. For 125 years we have served the interests of our customers, community, employees, and, as a result, our shareholders. We continue to attract talent with a customer-centric mentality and will continue to support their efforts through creativity and ingenuity to provide the valuable customer experience to which our clients have become accustomed. We have the best people in the industry, and I feel privileged to walk the halls with them each day.

Very truly yours,

A handwritten signature in black ink that reads "Frank H. Hamlin III". The signature is written in a cursive, flowing style.

Frank H. Hamlin, III
President

CANANDAIGUA NATIONAL CORPORATION

72 South Main Street
Canandaigua, New York 14424
Phone: 585-394-4260 or
1-800-724-2621
Fax: 585-394-4001
Internet: www.cnbank.com

2012 Annual Report

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Annual Meeting:

The Annual Meeting of Shareholders of Canandaigua National Corporation (the Company) will be held at the Main Office of The Canandaigua National Bank and Trust Company, 72 South Main Street, Canandaigua, NY, 14424; April 24, 2013, at 1:00 p.m.

Form 10-K:

Copies of the Company's Form 10-K Annual Report and the Company's Code of Conduct are available without charge to shareholders upon written request to: Steven H. Swartout, Secretary, 72 South Main Street, Canandaigua, New York 14424. Copies are also available at the website of the Securities and Exchange Commission (www.sec.gov) and by link from the website of the Company's subsidiary The Canandaigua National Bank and Trust Company (www.cnbank.com/your_bank/cnc_financials).

Forward-Looking Statements

This report, including information incorporated by reference, contains, and future filings by Canandaigua National Corporation on Forms 10-K, 10-Q and 8-K and future oral and written statements, press releases, and letters to shareholders by Canandaigua National Corporation and its management may contain, certain "forward-looking statements" intended to qualify for the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. When used or incorporated by reference in the Company's disclosures and documents, the words "anticipate," "believe," "contemplate," "estimate," "expect," "foresee," "project," "target," "goal," "budget" and similar expressions are intended to identify forward-looking statements within the meaning of Section 27A of the Securities Act. Such forward-looking statements are subject to certain risks discussed within this document and the Company's most recent Annual Report on Form 10-K, including under the heading "Risk Factors" in the Company's Annual Report on Form 10-K. These forward-looking statements are based on currently available financial, economic, and competitive data and management's views and assumptions regarding future events. These forward-looking statements are inherently uncertain, so should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, expected, projected, targeted, or budgeted. Certain matters which management has identified, which may cause material variations are noted elsewhere herein and in the Company's other publicly filed reports. These forward-looking statements speak only as of the date of the document. We expressly disclaim any obligation or undertaking to publicly release any updates or revisions to any forward-looking statement contained herein. We caution readers not to place undue reliance on any of these forward-looking statements.

Some examples of forward-looking statements include statements related to our expectations on the direction of interest rates, demand for our loans, changes in customer transactions types, and the payment performance of our loan portfolio. Our experience and assumptions we believe are reasonable to form the basis of our stated expectations, but results can also be impacted by other factors.

As described in our public filings, factors which may cause our results to vary materially from our expectations include, among many others, adverse changes in the global economy which may affect interest rates and as well as the stability of our local service areas, which may affect loan demand and credit quality; changes in fees related to servicing electronic transactions which may affect consumer usage, and continued focus of regulatory authorities at the state, federal and international level on bank regulation.

We present below a summary of selected financial highlights to help you see a snapshot of our performance for the past five years. Balance sheet information is as of the year end, while income statement and average balance information is for the full-year period. (All share and per-share information has been adjusted to reflect the 4-for-1 stock split in 2011). This and all information concerning our financial performance should be read in conjunction with the following Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as the Consolidated Financial Statements and Notes thereto. These sections help to provide context for the information you see here.

Financial Highlights
(Dollars in thousands except per share data)

	2012	% Change	2011	2010	2009	2008
Income Statement Information:						
Net interest income	\$ 65,603	6.72 %	61,473	61,141	54,374	47,485
Provision for loan losses	4,300	13.91 %	3,775	6,150	4,345	3,805
Non-interest income	35,123	21.92 %	28,808	26,721	24,770	22,454
Operating expenses	69,375	7.72 %	64,403	57,851	54,204	47,243
Income taxes	8,434	36.52 %	6,178	6,205	5,401	4,958
Net income attributable to CNC	18,837	15.48 %	16,312	17,656	15,194	13,933
Balance Sheet Data:						
Total investments ⁽¹⁾	\$ 281,357	(0.98)%	284,139	272,336	280,797	261,149
Total loans, net	1,441,455	12.93 %	1,276,426	1,189,221	1,145,707	1,076,620
Total assets	1,887,028	7.17 %	1,760,764	1,661,504	1,566,000	1,419,037
Total deposits	1,662,863	7.52 %	1,546,610	1,473,330	1,377,697	1,228,907
Total borrowings ⁽²⁾	55,843	(4.35)%	58,383	51,877	61,388	77,406
Total equity	144,363	6.75 %	135,238	123,794	111,735	100,438
Average assets	1,822,867	7.52 %	1,695,327	1,627,113	1,535,224	1,329,056
Average equity	138,171	7.62 %	128,393	116,696	104,196	95,004
Asset Under Administration:⁽³⁾						
Book value (cost basis)	\$ 1,879,397	8.88 %	1,726,172	1,658,111	1,591,943	1,573,960
Market value	2,115,346	13.84 %	1,858,130	1,830,549	1,651,777	1,450,021
Per Share Data:						
Net income, basic	\$ 9.98	15.51 %	8.64	9.35	8.06	7.36
Net income, diluted	\$ 9.76	15.09 %	8.48	9.20	7.93	7.24
Cash dividends ⁽⁴⁾	\$ 4.74	65.16 %	2.87	2.72	2.47	2.25
Book Value	\$ 74.64	6.01 %	70.41	65.54	59.33	53.21
Closing stock price ⁽⁵⁾	\$ 141.03	9.14 %	129.22	95.85	81.78	78.98
Weighted average share - diluted	1,929,360	0.29 %	1,923,777	1,919,192	1,917,512	1,926,044
Other ratios:						
Return on average assets	1.03 %	7.29 %	0.96 %	1.09 %	0.99 %	1.05 %
Return on average equity	13.63 %	7.32 %	12.70 %	15.13 %	14.58 %	14.67 %
Return on beginning equity	13.93 %	5.69 %	13.18 %	15.80 %	15.13 %	15.11 %
Dividend payout ⁽⁴⁾	48.57 %	43.53 %	33.84 %	29.48 %	31.23 %	31.10 %
Average equity to average assets	7.58 %	0.13 %	7.57 %	7.17 %	6.90 %	7.15 %
Net interest margin	4.02 %	(0.74)%	4.05 %	4.26 %	4.10 %	4.10 %
Efficiency ⁽⁶⁾	67.38 %	(3.77)%	70.02 %	64.71 %	67.14 %	66.04 %
Employees (year end)						
Total	537	3.47 %	519	481	459	430
FTE's	480	4.58 %	459	407	379	363

⁽¹⁾ Includes the Company's investment in Federal Reserve Bank stock and Federal Home Loan Bank stock.

⁽²⁾ Includes junior subordinated debentures.

⁽³⁾ These assets are held in a fiduciary or agency capacity for clients and are not included in our balance sheet. Beginning in 2008, the figures include our subsidiary Genesee Valley Trust's assets under administration.

⁽⁴⁾ Includes \$1.63 per share accelerated to December 2012 from February 2013.

⁽⁵⁾ For the respective year, price is based upon last sealed-bid auction administered by the Bank's Trust Department. Due to the limited number of transactions, the prices may not be indicative of the actual market value of the Company's stock or disclosed prices on OTC.BB.

⁽⁶⁾ Operating expenses, exclusive of intangible amortization, divided by total revenues.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The Management Discussion and Analysis (MD&A) is intended to provide, in one section, historical and prospective material disclosure enabling investors and other users to assess the financial condition and results of operations of the Company, with particular emphasis on our prospects for the future. It is intended to give you an opportunity to look through the eyes of your Company's management (we/us) by providing both a short-term and long-term analysis of our business. On the following pages, we will discuss the dynamics of our business and analyze our financial information through text and tables. (Dollar and percentage changes are calculated before rounding.)

Throughout this and other documents we prepare from time to time, we include our predictions (or "forward-looking information"). Of course, any discussion of the future is subject to many risks and uncertainties, and, while we seek ways to manage these risks and develop programs to control those we can, we ultimately cannot predict the future. Our actual results may differ materially from those indicated by our forward-looking statements. Significant risks and uncertainties affecting our business are enumerated below:

- The strength of the United States economy in general and the strength of the local economy in particular; general economic conditions, either nationally or locally could be less favorable than expected, resulting in, for example, a deterioration in credit quality of assets;
- The effects of and changes in United States trade, monetary, and fiscal policies and laws, including and most importantly, the interest rate policy of the Federal Open Market Committee (FOMC) of the Federal Reserve Board, which can have an immediate and significant impact on earnings;
- The impact of changes in laws and regulations governing financial services and public companies, including laws, regulations, and rules concerning taxes, accounting, auditing and reporting standards;
- The impact of the imposition of legislative or regulatory price controls on financial transactions;
- The cost of compliance with governmental regulations, particularly as a result of passage of *The Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Financial Reform Act")
- The impact of technological changes;
- The development of new products, their competitiveness, and their acceptance by customers;
- Changes in commercial and consumer spending and saving habits;
- Changes in demographics within the Company's market area;
- The commission of fraud by customers and non-customers against the Company; and
- Our success in managing these risks.

RESULT OF OPERATIONS

Messrs. Hamlin messages to shareholders in this Annual Report provide a further overview of the Company's 2012 results. They include a discussion of the economy, the banking industry, the regulatory environment, and their impact on the Company, as well as activities internal to the Company.

For the year ended December 31, 2012, we reported a 15.5% improvement in net income to \$18.8 million compared to \$16.3 million for the year ended December 31, 2011, and \$17.7 million for the year ended December 31, 2010. Diluted earnings per share for each of these years were \$9.76, \$8.48, and \$9.20, respectively. The major components of these results, which include net interest income, provision for loan losses, non-interest income, operating expenses, and income taxes, are discussed below.

Net interest income

Net interest income is the difference between the interest and dividend income earned on loans and investments and the interest expense paid on deposits and borrowings. Net interest income is the Company's principal source of earnings, comprising approximately 65% of total revenues. Net interest income is affected by a number of factors, including the level, pricing and maturity of interest-earning assets and interest-bearing liabilities, interest rate fluctuations and asset quality, as well as general economic conditions and regulatory policies.

As we entered 2012, we saw our local economy continue the slow recovery from the 2009 recession. The national economy was showing signs of improved performance, but the expectation was a slow-down from the fourth quarter of 2011. With slow growth, high unemployment, and little prospect for significant inflation, as previously noted, the FOMC signaled its willingness to maintain short-term interest rates at historically low levels into 2014. The impact to our balance sheet would be continued downward pressure on asset yields combined with some reduction in liability costs. This would erode both margin and spread. Thus, net interest revenue growth would have to come from higher volumes of loans, a strategy we pursued in 2012.

Our predictions of an improving economy were generally accurate. GDP growth was less than 2% in the first and second quarters of 2012, jumping to 3.1% for the third quarter, but the fourth quarter data showed a decline from the growth rate of the third quarter. Unemployment remains above 7%, and inflation below 2%. Given the continued relatively weak growth prospects, high unemployment, and low price inflation, the FOMC announced during the fourth quarter of 2012 that it expected to keep the target range for the federal funds rate at 0 to 1/4 percent through 2015, and possibly longer depending upon the unemployment rate.

As was seen in 2011, with rates remaining low for all of 2012, our asset yields declined significantly due to refinancing of existing loans and originations of new loans at lower rates than those maturing. Funding costs also decreased, despite being already at historical lows. During 2012 we continued our strategy begun in the second half of 2011 to implement a multi-loan portfolio effort to increase originations of short- to medium-term duration, higher yielding loans to replace low yielding investments in federal funds ("fed funds"). These efforts resulted in strong year-over-year growth in net interest income, despite a narrowing margin.

For 2012, tax-equivalent net interest income grew \$3.8 million or 5.8%. Impacting these results was a \$102.1 million (6.4%) increase in average earning assets, all in higher-yielding loans, and a \$52.4 million (3.9%) increase in average interest-bearing liabilities. During the year, the tax-equivalent yield on earning assets fell 26 basis points to 4.52%, while the cost of interest-bearing liabilities also fell by 26 basis points to 0.61%. The combination of these reductions led to stability of the net interest spread (the difference between rates earned and rates paid) at 3.91%, while net interest margin (net interest income divided by average earning assets, or balance sheet profit margin) fell to 4.02% from 4.05%.

In 2011, tax-equivalent net interest income grew less than \$0.1 million. Impacting these results was a \$76.3 million (5.0%) increase in average earning assets, mostly in low-yielding fed funds sold, and a \$37.6 million (2.9%) increase in average interest-bearing liabilities. During the year, the tax-equivalent yield on earning assets fell 47 basis points to 4.79%, while the cost of interest-bearing liabilities fell only 30 basis points to 0.87%. The combination of these reductions led to a 17 basis point decline in net interest spread and a 21 basis point decline in margin from 2010.

The following table provides additional details of net interest income and shows average balances, tax-equivalent interest earned or paid, and average rates for the years ended December 31, 2012, 2011, and 2010. Taxable securities include the Company's required investments in Federal Reserve Bank Stock and Federal Home Loan Bank Stock. The mark-to-market adjustments on securities available for sale are included in non-interest-earning assets. Nonaccrual loans are included in the average balances of loans. Non-interest-bearing demand deposit accounts are included in non-interest-bearing liabilities. Borrowings include junior subordinated debentures. Tax-exempt interest includes a tax equivalency adjustment of \$2,989,000 in 2012, \$3,342,000 in 2011, and \$3,646,000 in 2010. A marginal federal income tax rate of 35% was applied in each year. Interest on loans includes a deduction for net deferred loan costs of \$3,312,000 in 2012, \$2,067,000 in 2011, and \$2,043,000 in 2011. The substantial increase in deferred costs in 2012 is related to loan costs incurred to originate indirect automobile loans, which tend to have relatively short average life, leading to faster cost amortization than the entire loan portfolio in general.

Average Balances and Interest for the Years Ended December 31,
(dollars in thousands)

	2012			2011			2010		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Assets									
Interest-earning assets:									
Interest-bearing deposits with others	\$ 6,953	\$ 13	0.19 %	\$ 3,132	\$ 24	0.77 %	\$ 1,729	\$ 36	2.06 %
Federal funds sold	56,693	132	0.23	145,509	354	0.24	87,203	207	0.24
Securities:									
Taxable	59,421	1,327	2.23	58,541	1,505	2.57	48,373	1,547	3.20
Tax-exempt	217,240	8,677	3.99	214,985	9,773	4.55	224,272	10,750	4.79
Loans, net	1,365,953	66,963	4.90	1,178,132	64,907	5.51	1,161,172	67,571	5.82
Total interest-earning assets	1,706,260	77,112	4.52	1,600,299	76,563	4.78	1,522,749	80,111	5.26
Non-interest-earning assets									
	116,607			96,859			104,989		
Total assets	\$ 1,822,867			\$ 1,697,158			\$ 1,627,738		
Liabilities and Stockholders' Equity									
Interest-bearing liabilities:									
Interest-bearing demand Savings and money market	\$ 179,974	115	0.06 %	\$ 155,688	146	0.09 %	\$ 139,158	255	0.18 %
Time deposits	786,196	1,631	0.21	692,271	1,831	0.26	637,215	2,319	0.36
Borrowings	386,115	3,908	1.01	449,404	6,866	1.53	476,486	9,539	2.00
	52,878	2,865	5.42	51,575	2,905	5.63	57,256	3,212	5.61
Total interest-bearing liabilities	1,405,163	8,519	0.61	1,348,938	11,748	0.87	1,310,115	15,325	1.17
Non-interest-bearing deposits									
	252,751			207,551			187,957		
Other non-interest-bearing liabilities									
	26,782			12,276			12,970		
Stockholders' equity	138,171			128,393			116,696		
Total liabilities and stockholders' equity	\$ 1,822,867			\$ 1,697,158			\$ 1,627,738		
Interest rate spread									
			3.91 %			3.91 %			4.09 %
Net interest margin		\$ 68,593	4.02 %	\$ 64,815		4.05 %	\$ 64,786		4.25 %

The following rate/volume analysis is meant to show separately the relative contribution that changes in rates and in volume (balances) have on total tax-equivalent net interest income year over year. By looking at these components separately, we can identify the sources from which net interest income growth arises - changes in balances or changes in rates. Because each component requires different management techniques, for example: customer demand in the case of balances, and market interest rate changes in the case of rates, separating them gives us a clearer view for analyzing our results. In deriving the information, volume changes are

computed by multiplying the balance difference by the prior year's rate. Rate changes are computed by multiplying the rate difference by the prior year's balance. The change in interest due to both rate and volume has been allocated to rate and volume changes in proportion to the dollar amounts of the change in each.

We see from the analysis that substantially all of the interest income growth came from growth in loans. Changes in rates reduced the overall increase in income. As discussed previously, we had anticipated the potential impact of rate decreases, thus the reason why we set out in late 2011 to significantly increase total loans by reinvesting fed funds sold and new deposits. Deposit cost reductions provided an even greater benefit to net interest income. Parsing the data, we see it was principally due to, as anticipated, rate and volume reductions in time deposits, a product generally less attractive to savers during low interest rate periods.

	2012 compared to 2011			2011 compared to 2010		
	Increase/(decrease)			Increase/(decrease)		
	Due to change in			Due to change in		
	Volume	Rate	Total	Volume	Rate	Total
Interest-earning assets:						
Interest-bearing deposits with others	\$ 16	(27)	(11)	\$ 19	(31)	(12)
Federal funds sold	(207)	(15)	(222)	142	5	147
Securities, taxable	22	(200)	(178)	292	(334)	(42)
Securities, tax-exempt	102	(1,198)	(1,096)	(435)	(542)	(977)
Loans, net	9,673	(7,617)	2,056	976	(3,640)	(2,664)
Total	9,606	(9,057)	549	994	(4,542)	(3,548)
Interest-bearing liabilities:						
Interest-bearing demand	20	(51)	(31)	27	(136)	(109)
Savings and money market	228	(428)	(200)	187	(675)	(488)
Time deposits	(871)	(2,087)	(2,958)	(517)	(2,156)	(2,673)
Borrowings	72	(112)	(40)	(320)	13	(307)
Total	(551)	(2,678)	(3,229)	(623)	(2,954)	(3,577)
Net Change	\$ 10,157	(6,379)	3,778	\$ 1,617	(1,588)	29

Taking into account the results of 2012, and considering our expectation of continued low interest rates into 2015, we anticipate 2013 will be another year of narrowing net interest margin and spread as asset yields will continue to decline, and liability costs will have less and less opportunity for reduction. We remain encouraged that our local economy will grow, leading to opportunities for us to provide credit to growing business and households, resulting in loan and deposit growth. However, overall net interest income growth will be in the low single digits due to the impact of asset yield declines. Thus the contribution of net interest income to total revenues will fall below 65%. We will see our greatest revenue growth in non-interest income sources, which is discussed hereafter.

Provision for Loan Losses

The provision for loan losses (a charge to earnings) in each period is a result of our judgment about the credit quality of the Company's assets. We present a detailed discussion and analysis in a following section entitled "Loan Loss Experience and Allowance for Loan Losses" and Note 4 of the Consolidated Financial Statements.

Non-Interest Income

Non-interest income accounts for approximately 35% of total revenue, and growing, consistent with our strategy to broaden our revenue sources through providing comprehensive financial services. It is composed mainly of revenues from: (a) service charges on deposit accounts, (b) fees for trust and investment services (asset management), (c) income from brokerage and investment subadvisory services, and (d) net revenues from mortgage banking. For the year ended December 31, 2012, non-interest income increased \$6.3 million or 22.0% from 2011, and for the year ended December 31, 2011, it increased \$2.1 million or 7.8% from 2010.

Service charges on deposit accounts increased 6.8% in 2012 from 2011, attributable to both increased revenues from our Courtesy Limit service and electronic transaction services associated with our debit card. Service charges on deposit accounts increased 2.3% in 2011 from 2010 with growth only seen in electronic banking services. Account maintenance service charges (included in service charges) have been relatively flat the last three years due to higher customer balances offsetting their periodic fees. Courtesy limit-related service fees and electronic banking revenues continued to increase with consumers shifting from cash and checks (paper-based) to electronic transactions. We expect a similar trend in 2013, and will be exploring opportunities for targeted price changes to enhance this revenue source.

Trust and investment services income is earned based upon the fair value of assets under our administration. Income is further dependent upon the services we provide (managed or custodial) and the mix of assets underlying the accounts - stock, bonds, and money market funds. This income increased in 2012 by \$0.5 million or 3.8% from 2011, and increased in 2011 by \$1.5 million or 13.3% from 2010. For both 2012 and 2011, the increases in revenue were a result of an increase in the underlying fair value of assets under

administration (see table below), sales to new customers, and improved conditions in the stock market in general. We expect similar positive results in 2013 from a growing customer base and rising stock market, which should contribute to a high single-digit increase in both revenues and fair value of assets under administration. The table below presents information about recent period-end actual and average balances of assets under administration and the related income for the respective years (dollars in thousands).

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Book value of assets under administration (period end)	\$ <u>1,879,397</u>	<u>1,726,172</u>	<u>1,658,111</u>
Fair value of assets under administration (period end)	\$ <u>2,115,346</u>	<u>1,858,130</u>	<u>1,830,549</u>
Fair value of assets under administration (average)	\$ <u>1,988,061</u>	<u>1,869,900</u>	<u>1,685,694</u>
Trust and investment income	\$ <u>12,916</u>	<u>12,445</u>	<u>10,984</u>

Brokerage and investment subadvisory services income increased by \$2.5 million in 2012 from 2011. This increase as well as the increase from 2010 to 2011, were solely associated with our acquisition of OBS in late 2011. OBS's growing customer base and the related underlying assets are expected to contribute to revenue growth in excess of \$1.0 million in 2013.

Mortgage banking income is another important source of non-interest income and is comprised of the net gain on sale of mortgage loans and loan servicing income. Our residential mortgage originations are handled through our wholly owned subsidiary, CNB Mortgage Company (CNB Mortgage), with results primarily reflected in the net gain on sale of mortgage loans. Due mostly to changes in the volume of loans closed each year the line item grew over 85% in 2012 after having fallen 10.1% in 2011.

We typically sell long-term, non-callable, fixed-rate residential mortgages with loan-to-value ratios less than 85% to the Federal Home Loan Mortgage Corporation (Freddie Mac) to: (1) provide mortgage financing to homeowners we could not otherwise accommodate, primarily due to our inability to fund the high demand for these loans with local deposits; and (2) to reduce our long-term interest rate risk. However, we continue to service these loans locally with our staff. Generally, residential mortgage loans with an original loan-to-value ratio greater than 85%, and loans requiring escrow services, are sold with servicing released to third parties.

The revenue generated by CNB Mortgage is dependent upon the volume of loans originated. This volume is composed of purchase money loans (loans to purchase a property) and refinance loans (new loans that change the terms of an already existing loan). CNB Mortgage generally must originate approximately \$150 million annually to break even based on its current operating expense structure. This breakeven volume has increased significantly from less than \$100 million in prior years due to the impact of increasing costs expended as a result of regulatory changes, particularly enhanced disclosure requirements, appraisal requirements, and underwriting costs. During years without significant refinance activity, the Company is more dependent upon purchase money mortgages. Refinance activity in 2011 and 2010, while very strong, was much lower than in 2012 when mortgage interest rates kept falling. For the coming year we anticipate mortgage originations of about \$300 to \$330 million, somewhat lower than 2012's due to lower anticipated refinance activity. During each year, some of our originations are retained in the Bank's portfolio. The amount of loans retained is dependent upon the rates and terms of the mortgages. Generally, the Bank retains loans with interest rates of 4.00% or above and with maturities or call dates of ten years or less. Because of the low interest rate environment, a smaller percentage of total originations (20%-25%) have been retained in portfolio than in years past. For the years ended December 31, 2012, 2011 and 2010, CNB Mortgage originated and sold the following types of loans (dollars in thousands):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Purchase money mortgages	\$ 199,004	115,529	140,764
Refinance mortgages	<u>151,531</u>	<u>105,554</u>	<u>114,012</u>
Total mortgage originations	\$ <u>350,535</u>	<u>221,083</u>	<u>254,776</u>
Of which:			
Sold to third parties	\$ <u>271,815</u>	<u>166,240</u>	<u>203,582</u>
Sold to (retained by) the Bank	\$ <u>78,720</u>	<u>54,843</u>	<u>51,194</u>
Percentage of total sold to Bank	<u>22.5 %</u>	<u>24.8 %</u>	<u>20.1 %</u>

Net loan servicing income fell by 5.6% in 2012, after having increased 5.8% in 2011. This income source is composed primarily of service fees earned on loans sold to Freddie Mac but serviced by us, and service fees we earn on commercial loan participations, and reduced by amortization of loan servicing rights. (We discuss loan servicing rights in greater detail in Note 6 to the Consolidated Financial Statements. Residential loans sold to Freddie Mac and commercial loan participations are not included in the consolidated balance sheet, since the interest income earned is not ours.) Net loan servicing income grew in 2011 due to higher underlying serviced loan balances and relatively lower amortization expense for loan servicing assets. Despite overall growth in serviced loans, the higher volume of refinancing in 2012 led to higher loan payoffs of previously-originated serviced loans, resulting in comparatively higher amortization of servicing rights. Amortization expense was about \$0.1 million higher in 2012 than either 2011 or 2010. With continuing

low interest rates, we expect loans serviced for Freddie Mac to increase further in 2013 as long as 30-year fixed-rate mortgages stay at or below 4%. Given our positive outlook for commercial loan demand we also expect participation loans to increase in the coming year, reversing a multi-year decline. As a result of both of these factors net loan servicing income should increase. At each of the three years ended December 31, 2012, 2011, and 2010, we were servicing the following types of loans (dollars in thousands):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Residential mortgages (sold to Freddie Mac)	\$ 528,316	461,950	435,220
Commercial loans and mortgages (participations sold)	109,365	114,969	116,111
Total loans serviced for others	<u>\$ 637,681</u>	<u>576,919</u>	<u>551,331</u>

The Company's contract to sell loans to Freddie Mac and to the Federal Housing Administration (FHA) via third-parties contain certain representations and warranties that if not met by the Company would require the repurchase of such loans. The Company has not historically nor currently been subject to a material volume of repurchases.

Included in non-interest income are losses on security transactions. In each of the years 2011 and 2010, we recorded modest write-downs on a collateralized debt obligation (CDO), which accounted for a portion of the net losses on securities in these years. The remainder was mostly due to losses on called securities resulting from recognition of unamortized premiums. No such write-downs occurred in 2012. In the fourth quarter of 2011 we sold approximately 60% of our holdings in this CDO for a modest loss and expect to sell the remainder in the coming years as tax-loss planning opportunities arise. Net of these write-downs and sale, we hold approximately \$0.1 million in carrying value of these types of securities with an original remaining cost basis of \$0.5 million, representing an immaterial portion of our total securities portfolio. While future writedowns or a loss on the sale of the CDO could occur, the maximum amount would not exceed its carrying value of less than \$0.1 million.

All remaining sources of non-interest income rose \$0.8 million in 2012 and \$0.5 million in 2011. Income grew in both years due to higher income from our investment in Cephias Capital Partners, a Small Business Investment Company. We expect these sources of non-interest income to be similar in 2013 as in 2012. We expect continued earnings from Cephias, as it liquidates its positions, and we expect all other revenue sources to rise consistent with our underlying growth.

Operating Expenses

Operating expenses grew \$5.0 million or 7.7% in 2012 from 2011. Included in this growth figure is \$3.9 million associated with the full-year impact of OBS, which compares to \$1.3 million in operating expenses for OBS in 2011. In 2011, operating expenses increased \$6.6 million, with half (\$3.3 million) due to acquisition costs related to OBS (included in Professional and Other Services), and a higher accrual for the Stock Appreciation Rights Plan ("SAR Plan") liability (included in Salaries and Employee Benefits). With the exception of these unusually large expenses, most year-over-year increases were reflective of continued growth in our operations and expansion in Monroe County, New York and Sarasota, Florida. As a highly service-oriented financial company we continue to see the largest dollar increase in any category was in salaries and employee benefits and was attributable to increased staffing and raises for incumbent employees. For 2013, we expect further increases in total operating expenses due to our franchise growth.

Substantially all of the increase in salaries in the past two years has been due to wage increases and new staff, including OBS at a cost of \$1.8 million in 2012. Benefit costs declined in 2012 due to a lower accrual for the SAR Plan than in 2011. The increase in 2011 was principally driven by significant SAR Plan accrual (\$3.1 million in 2011 compared to \$0.6 million in 2010) [See Note 14 to the Consolidated Financial Statements], which was a result of a combination of a higher stock price and lower long-term interest rates. For 2013, salaries and benefit costs should increase about 2-4% from 2012.

Occupancy expenses increased \$0.6 million (8.1%) in 2012 over 2011 and \$0.7 million (10.7%) in 2011 over 2010. OBS accounted for \$0.4 million of the increase in 2012. For all years, rent expense associated with our new offices – Greece-Latta, Jackson Ridge, and Alex-Park– along with rent increases and additional rent expense resulting from our branch sale-leaseback transaction in June 2008, were the largest contributor to the increases. (Please also see Notes 5 and 15 to the Consolidated Financial Statements.) Occupancy expenses can also fluctuate depending upon growth in the Company and the timing and nature of capital expenditures and cosmetic renovations. General growth in the Company's operations will result in higher occupancy expenses due to greater purchases, year-over-year cost increases due to inflation and more rentable square footage. However, the timing of purchases and the age of equipment will impact depreciation expense, which will diminish after the depreciation period expires, even if the equipment is still being used. In 2013, we expect to see higher occupancy expenses due to increases in rent and depreciation, as well as renovation costs associated with physical improvement investments in our facilities and related equipment.

Technology and data processing expenses increased \$0.8 million or 18.5% in 2012 over 2011 and increased \$0.6 million or 15.4% in 2011 over 2010 with OBS accounting for \$0.2 million of the 2012 increase. The 2012 and 2011 increases were mostly due to higher software maintenance costs and software amortization, which have increased due to the impact of recent systems upgrades associated with franchise growth and technology improvements. We are also incurring growing expenses for debit card processing services, but these costs are growing at a slower rate than their related income. In 2013 and forward we expect these same expenses to increase reflecting the Company's growth.

The largest components of professional services are contract costs, with the largest recurring contract costs being subadvisor investment fees. Because these fees are tied to the underlying market value of applicable assets under administration, they will fluctuate from year to year. In 2012 compared to 2011, these fees fell, because those paid to OBS since its acquisition are eliminated in consolidation. The drop in these fees was offset by an increase in credit reporting fees associated with the increased volume of loans originated. However, the largest component of the decrease was due to fees incurred in 2011, not recurring in 2012. In 2011 \$1.1 million of professional fees were incurred related to the acquisition of OBS. For 2013 we expect this category to continue to rise with increases associated with growth in the market value of managed assets, and fees to consultants and professionals.

Marketing (advertising and promotion) and public relations (contributions and entertainment) expenses increased \$0.2 million in 2012 from 2011 and \$0.3 million in 2011 from 2010. Increases in 2012 were associated with promotional activities associated with the Bank's 125th anniversary celebration, as well as increased charitable contributions, and costs for on-boarding new deposit customers. The increase in 2011 was mostly due to advertising and promoting our new offices and media spending for brand management. In general, though, as with occupancy expenses, some underlying expenses continue to grow with overall Company growth and inflation, while others fall due to the timing of expenditures. Included in public relations expenses is our monetary commitment to our communities as measured by our contributions to community organizations which amounted to \$390,000, \$339,000, and \$303,000 for 2012, 2011 and 2010, respectively. We expect marketing and public relations expenses will show a nearly 10% increase in 2013 for promotional activities surrounding the PGA Championship in Rochester, NY, and costs associated with re-branding at GVT and OBS.

Office-related expenses increased \$0.1 million in 2012 due to check printing costs associated with new business deposit accounts, while in 2011 and 2010 they were relatively flat at \$1.5 million. Despite growth in customers, staff and physical locations, we have been able to manage the overall growth in these costs through continuing investment in cost-saving technology, including electronic communications. Notwithstanding these process improvements, for 2013 it is expected that these expenses will increase due to branding efforts at subsidiary companies combined with higher postage rates.

Intangible amortization expense was \$1.5 million in 2012 and increased from \$1.2 million in 2011 due to the addition of OBS intangible assets. In the fourth quarter of 2011, as a result of the Company's annual fair value estimation, an additional \$0.3 million amortization expense over scheduled amortization was recorded to reflect customer account attrition in excess of original estimates at GVT. We believe this higher attrition rate was associated with customers transferring their accounts to a firm started by employees who left the Company. Similar attrition did not recur in 2012. Details of future amortization expense are found in Note 2 to the Annual Report.

Expenses associated with operating other real estate were \$0.8 million in 2012, \$1.0 million in 2011, and \$1.3 million in 2010. These comparatively high levels of historical expenses are mostly associated with our acquisition of nearly 60 rental properties from a commercial borrower through foreclosure in the first quarter of 2009. We have been successful during the years in selling some of these properties, and expect to sell more in 2013. Operating expenses for managing these and the handful of other properties approximated \$0.7 million in 2012 and \$0.8 million in both 2011 and 2010 with the balance of the expense associated with valuation writedowns. We regularly review the carrying value of foreclosed properties to determine if their fair value has fallen based upon then current market conditions. We continue to market these properties with a goal to liquidate them. Associated operating expenses will be directly impacted by the timing and number of properties sold, and new properties which might be acquired through future foreclosures.

Despite growth in deposits, FDIC insurance expenses in recent years have fallen due to changes in assessment methodologies. In 2012, insurance costs fell \$0.2 million, while they fell \$0.7 million in 2011 and \$0.4 million in 2010 after having tripled in 2009 when it included a special \$0.7 million assessment paid in the second quarter of that year. At the end of 2009, we, and all banks, prepaid an estimated thirteen quarters of insurance premiums with approximately \$2.8 million remaining at December 31, 2012. Over the past several years the FDIC had raised insurance premiums to cover substantial losses incurred by its insurance fund due to actual and anticipated bank failures. In October 2010, the FDIC announced that it will extend the period to reach its maximum reserve levels, and combined with lower loss projections, eliminated the three (3) basis point premium increase scheduled for 2011. In the first quarter of 2011, the FDIC finalized its new assessment system in accordance with the Financial Reform Act. The changes became effective beginning mid 2011 and were assessed against our prepayments to the FDIC. The FDIC Board approved a final rule that changed the assessment base for deposit insurance, adopted a new large-bank pricing assessment scheme, and set a target size for the Deposit Insurance Fund. The rule -- as mandated by the Dodd-Frank Act -- finalized a target size for the Deposit Insurance Fund at 2 percent of insured deposits. It also implemented a lower assessment rate schedule when the fund reaches 1.15 percent and, in lieu of dividends, provided for a lower rate schedule when the reserve ratio reaches 2 percent and 2.5 percent. As mandated by the Financial Reform Act, the rule changed the assessment base from adjusted domestic deposits to a bank's average consolidated total assets minus average tangible equity. The rule defined tangible equity as Tier 1 capital. The rule lowered overall assessment rates in order to generate the same approximate amount of insurance premiums under the new larger base as was raised under the old base. The largest banks (over \$10 billion in assets) pay higher insurance premiums than under the previous formula, while smaller banks, ours included, pay lower relative premiums. When fully implemented, assuming no change in deposit base, we estimated our annualized premiums would fall as much as \$1.0 million. In 2013, with our continued growth, premium expenses are expected to rise over 2012, but not to the extent seen prior to the rule change.

All other operating expenses grew \$0.8 million in 2012 with about one-third due to OBS, and the remainder due to a variety of costs associated with our growth. Expenses fell about \$0.3 million in 2011 and grew about \$0.4 million in 2010 with no particular material item. For 2013, we expect to see some modest expense growth in this category consistent with the Company's growth.

Income Taxes

Our effective income tax rate was approximately 31%, 28%, and 26% in each of the past three years, respectively. These effective rates differ substantially from our marginal rate of about 40%, mainly due to our significant non-taxable interest income from state and municipal obligations. A detail of their impact can be found in Note 10 to the Consolidated Financial Statements. The rise in rate in 2012 and 2011 is directly attributable to lower tax-exempt income, which was caused by lower market interest rates. We anticipate our 2013 effective tax rate will be in the 30% to 33% range and is mostly dependent upon the amount of non-taxable interest income we earn in proportion to taxable income, as well as the fiscal policy of New York State and the U.S. Government.

FINANCIAL CONDITION

As of December 31, 2012, total assets of the Company were \$1,887.0 million up \$126.2 million or 7.2% from \$1,760.8 million at year-end 2011. Substantially all of the asset increase occurred in the loan portfolio. Asset increases were principally funded by deposit inflows, continuing a multi-year trend as customers sought the safety and convenience of community banks, and to a lesser extent, redeployment of fed funds sold.

Cash and due from banks, including interest-bearing accounts, fell \$2.7 million to \$56.5 million, due to lower balances in the course of collection through the Federal Reserve Bank of New York. While this balance can fluctuate from day to day, depending upon customer transactions, we expect it to range between \$30 million and \$50 million on average. While endeavoring to maintain a sufficient supply of cash for our customers' needs, we also strive to minimize the amount of physical cash on hand, since this is a non-interest earning asset.

Federal funds sold were \$34.6 million at year end 2012, down from \$67.5 million at year end 2011. These balances generally reflect liquidity (cash) not invested in securities or loans. These balances are managed on a daily basis by representatives of our Asset/Liability Management Committee (ALCO). This liquidity is used to manage daily cash inflows and outflows from deposits and loans. Our floor target for federal funds sold balances is \$20 million to \$40 million, but day-to-day balances will fluctuate. During 2012, we averaged about \$56.7 million down from \$145.5 million in 2011. In 2011 the balance far exceeded our target as local demand for loans was lower than the amount at which deposits were growing, and a reasonable supply of liquid securities providing sufficient yields were not available for purchase. Foreseeing market rate stability for several years, and improvements in the local economy, during the second half of 2011 we aggressively grew our loan portfolio with high quality automobile loans, which reduced the fed funds balance by year's end, and in 2012 we continued the loan growth with residential and commercial loans. For 2013, we expect federal funds sold balances to remain near their current level, which exceeds our target, due to a continuation of the general trend of deposit growth exceeding net loan originations.

Net premises and equipment fell \$1.0 million in 2012 as depreciation expense exceeded new assets capitalized, while in 2011 it increased \$1.7 million due to costs of our new banking branch, renovations to existing offices, and purchases of new equipment. During each of the past few years, we have annually invested approximately \$3.0 million to \$4.0 million in premises and equipment, mostly for office improvements and technology upgrades. For 2013 we expect to begin construction of a new office at CollegeTown at the University of Rochester, and an associated stand-alone drive-up ATM facility. In total we anticipate investing about \$3.0 million to \$4.0 million for these and for existing facility renovations and equipment replacements with the remainder for computer hardware purchases. These investments have been, and will be, funded from current operating cash flow.

Goodwill and intangible assets fell due to amortization of the intangibles. During 2012 we finalized our estimate of the fair value of assets acquired and liabilities assumed in connection with the acquisition of OBS. Compared to our original estimates, the value of the technology and customer list intangibles increased, while the value of the non-controlling interest declined, and the net change impacted goodwill and deferred taxes. However, in accordance with current accounting guidance, these changes were applied retrospectively to 2011. More detail is presented in Note 2 to the Consolidated Financial Statements.

Prepaid FDIC assessment declined \$1.1 million due to credits posted for the past four quarters' assessments. At December 31, 2012, this balance was \$2.8 million compared to \$3.9 million at December 31, 2011. In the fall of 2009, the FDIC proposed and approved a requirement that insured institutions prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012 (thirteen quarterly periods). The prepaid assessment for these periods was collected on December 30, 2009. The prepaid assessment rate was based on the Bank's total base assessment rate for the third quarter of 2009. The prepaid assessment rate for 2011 and 2012 was equal to the Bank's modified third quarter 2009 total base assessment rate plus three (3) basis points. Each institution's prepaid assessment base, including ours, was calculated using our third quarter 2009 assessment base, adjusted quarterly for an estimated five (5) percent annual growth rate in the assessment base through the end of 2012. We recorded the entire amount of this prepaid assessment as a prepaid expense (asset) as of December 31, 2009. As of year-end 2009, and each quarter thereafter, we record an expense (charge to earnings) for our regular quarterly assessment for the quarter and an offsetting credit to the prepaid assessment until the asset is exhausted. If the prepaid assessment is not exhausted by December 30, 2014, any remaining amount will be refunded to the Bank. Given the change in assessment methodology discussed in the Operating Expenses section above, we believe it is possible there will be a refund to our Bank.

Other assets increased \$3.2 million by year-end 2012 to \$26.7 million. The increase was associated with mortgage servicing rights, which are more fully described in Note 6 of the 2012 Consolidated Financial Statements, and deferred taxes, which are more fully described in Note 10.

A more detailed discussion of the Company's principal interest-earning assets (securities and loans), and interest-bearing liabilities (deposits and borrowings), follows.

Securities Portfolio

We maintain our portfolio of (investment) securities mostly in U.S. Treasury, U.S. government sponsored enterprise obligations ("U.S. GSE's" or "GSE's"), and municipal obligations. We invest in securities with short to intermediate average maturities in order to better match the interest rate sensitivities of our other earning assets and liabilities. You can find more information about the carrying value of our securities in Note 3 to the Consolidated Financial Statements.

Investment decisions are made within policy guidelines established by our Board of Directors. The investment policy is based on and supplements the Company's Interest Rate Risk and Funds Management Policy (ALCO Policy), also established by our Board. Together these policies set financial and investment goals, which direct investment in all assets, including securities. The investment policy states that "... the Company shall invest funds not needed for local loans and mortgages in United States Government Bonds, GSE's, Municipal Bonds, Corporate Obligations, and Money Market Instruments. The goal of the investment portfolio shall be to provide sufficient safety and liquidity in order to help meet the Company's needs and to produce income for the Company consistent with the safety features of quality, maturity, marketability, and risk diversification." The investment policy further limits total investments to no more than 40% of total Company assets. There are additional limits on asset classes (U.S. Treasury, GSE's, etc.), issuers, credit quality and maturities. Allowed within our policy are securities hedging activities, interest rate risk swaps, and other programs involving the use of off-balance-sheet derivatives.

We classify securities as either "available for sale" or "held to maturity." These classifications result in differing management and accounting treatments. Securities "available for sale" are used to absorb our available liquidity not used for lending purposes or not sold in the federal funds market. These securities may or may not be held to their stated maturity, as demand for loan and deposit in- and out-flows change. Securities which we have both the ability and intent to hold to maturity are classified as "held-to-maturity." Substantially all of these securities are pledged to collateralize municipal deposits. Municipalities in New York State are generally required to secure deposits in excess of FDIC insurance limits so these deposits are collateralized by eligible securities.

During 2012, total investment securities fell \$2.9 million by year end. Throughout most of the year, as with 2011, we experienced a high volume of security calls (i.e., issuers repaid debt obligations before their stated maturities). The continued low interest rate environment made it beneficial for issuers to call outstanding higher cost debt and replace with lower cost debt. Because market rates have been low for some time, and most of the portfolios' higher yielding callable securities have already been called, we expect calls of current portfolio securities to slow, allowing us to continue to modestly increase the portfolio balance, but at interest rates lower than those maturing or called.

Substantially all of the held-to-maturity portfolio is used to support the collateralization of the communities' funds in the form of municipal deposits. At December 31, 2012, about 75% of our total investment portfolio (available-for-sale and held-to-maturity) was used to collateralize these deposits. These deposits, in turn, are used to purchase tax-exempt securities of local municipalities, thereby recycling local deposits within our communities. Other securities consist mainly of triple-A rated taxable GSE's – Federal Home Loan Bank, Fannie Mae, Freddie Mac, and Federal Farm Credit Bank. We will vary the mix of taxable and tax-exempt securities from time to time depending upon the amount of our taxable income, the securities' tax-equivalent yield, and the supply of high-grade, tax-exempt securities.

Because changes in the interest rate environment impact the market value (price or fair value) of securities and because market interest rates often differ from the rates at which securities were purchased, the underlying price of securities will vary from time to time. The price of a security will move inversely to interest rates. So, generally, if market rates are higher than that of the security, the fair value of the security will be lower than our cost. On the other hand, if market rates are lower than those of the security, the fair value of the security will be higher than our cost. Since 2008, market rates have declined regularly resulting in relatively higher market values for our securities than their cost, particularly for state and municipal obligations. At December 31, 2012 the fair value of our securities exceeded their amortized cost basis by \$5.9 million or 2.1%. We expect market rates to remain low in 2013, generally not impacting current fair values. However, with the maturities and calls of securities, new purchases will carry then-current market rates, so the fair value of our securities is likely to fall closer to their amortized cost over time. Additionally, yields available on securities remain at market cycle lows, so as we purchase lower-rate securities, and if market rates subsequently rise, the fair value of these securities may fall below their cost. Notwithstanding the lower rate environment, even at December 31, 2012, the fair value of some individual securities remained below cost, as more fully discussed in Note 3 to the Consolidated Financial Statements. None of these securities was considered to be other than temporarily impaired as of December 31, 2012, therefore no write-down of carrying value in the income statement was required.

Securities available for sale are carried at estimated fair value. In addition, all securities are evaluated for "other-than-temporary-impairment," which can result, as in the past several years, in the write-down of securities to fair value with a resulting charge to earnings and to capital. The valuation of securities can involve a significant amount of judgment, particularly when liquid markets do not exist for the security being valued. We use quoted market prices to estimate fair value when an active market for the securities exist. However, when an observable liquid market does not exist, we utilize significant estimates and assumptions to estimate fair value. These assumptions, include among others, discount rates, expected cash flows, and default rates. The use of different

assumptions from ours could produce significantly different results, which could have a material effect on our other comprehensive income. Because of the level of judgment involved, we consider the valuation of securities a critical accounting estimate. Note 3 to the Consolidated Financial Statements provides additional information about the fair value of securities.

The following table summarizes the maturities and weighted average yields of debt securities available for sale and held to maturity at their carrying value at December 31, 2012. In this table, we do not reflect yields on a tax-equivalent basis. Our small balance in mortgage backed securities is reported at its final stated maturity, notwithstanding that principal is prepaid regularly, reducing its effective maturity. Some securities in the table below can be called by the issuer prior to their stated maturity.

Maturities and Yields of Debt Securities at December 31, 2012
(dollars in thousands)

	One Year or Less		After One through Five Years		After Five through Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for Sale								
U.S. Treasury	\$ 400	0.25 %	100	0.21 %	-	- %	-	- %
U.S. GSE's	2,022	0.76	4,000	1.36	51,422	1.44	2,714	3.77
State and municipal	12,395	3.26	25,002	2.94	115	1.47	-	-
Corporate	-	-	-	-	-	-	1,073	1.66
Total	<u>\$ 14,817</u>	<u>2.84 %</u>	<u>29,102</u>	<u>2.71 %</u>	<u>51,537</u>	<u>1.44 %</u>	<u>3,787</u>	<u>3.17 %</u>
Held to Maturity								
U.S. GSE's	\$ -	- %	5	3.13 %	-	- %	-	- %
State and municipal	31,638	3.26	133,951	2.08	9,476	1.30	-	-
Corporate	-	-	-	-	-	-	780	5.51
Total	<u>\$ 31,638</u>	<u>3.26 %</u>	<u>133,956</u>	<u>2.08 %</u>	<u>9,476</u>	<u>1.30 %</u>	<u>780</u>	<u>5.51 %</u>

Loans

Presented in Note 4 to the Consolidated Financial Statements is a description of the types of loans we make. What follows is a historical table of their balances. The Bank's loan policies establish the general parameters of the types of loans that are desirable, emphasizing cash flow and collateral coverage. Credit decisions are made at the Bank by officers who have extensive experience with commercial and consumer lending, helping to ensure thorough underwriting and sound credit decisions. Our Board of Directors has approved policies for commercial, consumer, and residential mortgage loans. These policies establish the lending authority of individual loan officers as well as the loan authority of the Bank's Officers Loan Committee (OLC). Certain of the Bank's executives each have loan authority up to \$1,000,000 while other officers' lending authorities are \$250,000 or less. A combination of officers and credit analysts can jointly approve certain loans up to \$500,000 and OLC up to \$4,000,000. Loans over that amount generally must be approved by the Board or a designated committee of the Board.

Loans are generally originated in our primary market area (Rochester Metropolitan Statistical Area [MSA]), but as a national bank, we can make loans to customers anywhere in the country. We use the same credit principles and guidelines for small, medium, and large credits. A borrower's cash flow, overall financial condition/capacity, character, and the collateral securing a loan are considered during the credit decision process. Specific emphasis is placed on the borrower's ability to generate cash sufficient to cover operations and financing costs when assessing the overall quality of a borrower's financial condition. The commercial loan policy imposes limits on loans to one borrower and any borrowing relationship, as well as concentrations of credit to particular industries. Federal banking regulations limit loans to one borrower (as defined) to 15% of the lending institution's regulatory capital. At December 31, 2012, this limit for the Bank was approximately \$26.0 million, and the Bank's largest committed borrowing relationship under these regulations was \$15.7 million.

For all years, the loan portfolio was composed solely of domestic loans with their concentrations set forth in the schedule of loan classifications below. We are not aware of any material concentrations of credit risk to any industry or individual borrower. The following summary shows the classifications of loans by category as of the year end for the past five years.

Summary of Loans by Category
As of December 31,
(dollars in thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
Commercial and industrial	\$ 213,467	\$ 198,744	\$ 212,707	\$ 214,841	\$ 205,818
Mortgages:					
Commercial	525,413	467,413	434,787	429,955	389,907
Residential - first lien	286,972	256,173	232,953	218,731	213,411
Residential - second lien	100,099	101,877	96,416	83,236	75,971
Consumer:					
Automobile - indirect	283,836	227,541	181,481	171,902	168,830
Other	18,323	25,583	26,437	28,919	25,999
Other, including loans held for sale	<u>21,113</u>	<u>7,556</u>	<u>14,113</u>	<u>6,657</u>	<u>2,900</u>
Total loans	1,449,223	1,284,887	1,198,894	1,154,241	1,082,836
Plus - Net deferred loan costs	9,549	7,634	5,962	5,698	5,776
Less - Allowance for loan losses	<u>(17,317)</u>	<u>(16,095)</u>	<u>(15,635)</u>	<u>(14,232)</u>	<u>(11,992)</u>
Loans - net	<u>\$ 1,441,455</u>	<u>\$ 1,276,426</u>	<u>\$ 1,189,221</u>	<u>\$ 1,145,707</u>	<u>\$ 1,076,620</u>

As planned, gross loans increased significantly in 2012, rising \$166.3 million (12.9%) with growth occurring in all major loan categories-commercial, mortgage, and indirect automobile. The largest dollar increases occurred in commercial mortgages and automobile loans, which were the focus of our origination efforts. We also targeted significant residential loan growth for 2012, but with continued low interest rates, we sold most originations to the secondary market to reduce long-term interest rate risk in our balance sheet. Notwithstanding, we did grow that portfolio over \$30 million through our 5-year and 10-year callable mortgages.

Excluded from the balances in the table are loans serviced for others, the balances of which are discussed in the Non-interest Income section. We sell many originated residential mortgage loans and sell participation interests in some large balance commercial loans to manage liquidity, interest rate, and credit risk, but retain the servicing to continue to accommodate the needs of our customers and retain their relationship.

Overall, we are projecting the net balance of loans across all categories to increase approximately 4.0% in 2013, a slower pace than in 2012, but we will adjust this rate depending upon corresponding growth in deposits, market interest rates for loans, and our level of capital formation. We expect to continue to manage the overall mix of loans -- commercial and individual (mortgage and consumer) -- near a 50% / 50% mix. Since our expansion beginning in the late 1990s, the loan portfolio mix had moved from 50% commercial, 50% individual to a high of 64% / 36%, and stood at 51% / 49% at year-end 2012. We believe a balanced mix of these assets provides an optimal level of credit, interest rate, and liquidity risk. To accomplish these goals over time, we will increase consumer loans as well as first- and second-lien residential real estate loans, except when low interest rates lead us to sell residential mortgages rather than retain in portfolio. Additionally, we will continue to utilize commercial loan participations.

In January 2013, the Consumer Financial Protection Bureau (CFPB) issued its final rule regarding Qualified Residential Mortgages (QRM). The CFPB's final rule, which takes effect Jan. 10, 2014, implements laws requiring mortgage lenders to consider consumers' ability to repay home loans before extending them credit, a consideration we have always made prior to extending credit. Included in the rule is a definition of "qualified mortgage" loans, which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. Among its provisions, the rule provides a safe harbor for loans that satisfy the definition of a qualified mortgage and are not deemed to be "higher-priced" loans, which will help avoid unnecessary litigation. Further, the rule treats balloon-payment loans as qualified mortgages if they are originated and held in portfolio by small creditors operating predominantly in rural or underserved areas. Unfortunately, this definition excludes our Company. We are evaluating these rules and their potential impact on our current products and our future balance sheet. We are particularly concerned about the potential for the proposed rule to impact our callable mortgage product (a \$282 million portfolio at year-end 2012), which is not a balloon mortgage. The CFPB is also seeking comment on modifications to the final rule that would extend the safe harbor, qualified mortgage designation to additional loans originated and held in portfolio by community banks with less than \$2 billion in assets, but we will quickly outgrow this measure.

Loan Quality

Poor credit quality can be devastating to a bank, as the world experienced during the end of the last decade. Therefore, we are diligent in initial underwriting and subsequent asset management to measure, monitor and manage credit risk. The quality of the loan portfolio, as measured by the ratio of non-performing loans to total loans, has mirrored the economy, with the measure worsening in the early years of the decade and improving since then, and declining once again during the most recent recession. Total non-performing loans increased \$0.2 million from December 31, 2011 to December 2012, but declined to 1.28% of the loan portfolio from 1.42%, respectively. At December 31, 2011, non-performing loans fell by \$4.6 million from 2010 when they stood at \$22.8 million and were 1.90% of the loan portfolio. The highest balances of non-performing loans are concentrated within commercial relationships with about half of the balance primarily in the recreation sector – an industry impacted by the recession. We are actively working with the borrowers with credit difficulties. Our focus is to direct them towards resolving their cash flow issues by addressing the root-causes of their business troubles, rather than forcing business bankruptcy or liquidation. We believe this strategy provides longer term value to the Company, the community, and to our customers and their employees, but at times it can result in a higher ratio of non-performing assets relative to our peers, because of our conservative non-accrual policy. During the past three years we have also seen an increase in non-performing residential loans. This increase is also tied to the effects of the recession, as a number of borrowers continue to struggle making monthly payments. We work with each individually for a positive result, including short-term interest deferrals, financing in government-sponsored programs, and refinancing portfolio loans. Even with these community-focused strategies for troubled-loan resolution, borrowers' circumstances can deteriorate rapidly and we could suffer significant losses. As of December 31, 2012 we believe we have adequately reserved for this risk within the allowance for loan losses. More information about the reserves established for these impaired loans is included in Note 4 to the Consolidated Financial Statements.

To ensure that we only report income we have or expect to receive, the accrual of interest on commercial and real estate loans is generally discontinued, and previously accrued interest is reversed, when the loans become 90 days delinquent or when, in our judgment, the collection of principal and interest is uncertain. Loans are returned to accrual status when the doubt no longer exists about the loan's collectability and the borrower has demonstrated a sustained period of timely payment history. Specifically, the borrower will have resumed paying the full amount of scheduled interest and principal payments; all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period (six months); and there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms involving payments of cash or cash equivalents. Interest on consumer loans is accrued until the loan becomes 120 days past due at which time principal and interest are generally charged off.

Interest can be earned on a cash basis for these loans in non-accrual status, and it was: \$433,000 in 2012, \$127,000 in 2011, and \$35,000 in 2010. The substantial increase in 2012 is related to the successful resolution of a long-standing non-accrual loan for which we recovered all past due interest owed. Had non-accrual loans been current in accordance with their original terms, we would have recognized additional interest income approximating \$596,000, \$743,000 and \$429,000 during 2012, 2011, and 2010, respectively. Instead these cash payments received were applied to reduce our carrying amount of the loans.

Occasionally we must foreclose on mortgaged properties. These foreclosed properties are initially recorded at the lower of their fair value, including estimated costs to sell, or carrying value and are included in other real estate owned in the Other Assets section of the balance sheet. At December 31, 2012, we had four commercial properties and 36 residential properties in other real estate owned. In the first half of 2009 we took possession of 60 one-to-four-family residential rental properties associated with the foreclosure of a commercial loan relationship that was in non-accrual status at December 31, 2008. At the time, the estimated fair value of the properties was significantly higher than their carrying value, their combined cash flow was positive, exclusive of non-recurring expenses, such as major repairs, and nearly all properties were occupied by tenants. At year end 2012, 15 of these properties remained in other real estate. Since our foreclosure we have experienced higher than anticipated repair costs, lower revenues, higher vacancies, and lower proceeds from sales. As a result, and in consideration of current market conditions we wrote down the value of these properties by \$0.3 million in the fourth quarter of 2010. No subsequent writedowns have been taken on these properties. As indicated by our current inventory, we have successfully liquidated most of these properties, as well as other properties formerly foreclosed. As with non-performing loans, we can anticipate additions and dispositions of other real estate in the future.

In the process of resolving nonperforming loans, we may choose to restructure the contractual terms of certain loans and attempt to work out alternative payment schedules with the borrower in order to avoid foreclosure of collateral. Any loans that are modified are evaluated to determine if they are "troubled debt restructurings (TDR)" and if so, are evaluated for impairment. A TDR is defined as a loan restructure where for legal or economic reasons related to a borrower's financial difficulties, the creditor grants one or more concessions to the borrower that it would not otherwise consider. Terms of loan agreements may be modified to fit the ability of the borrower to repay in respect of its current financial status and restructuring of loans may include the transfer of assets from the borrower to satisfy debt, a modification of loan terms, or a combination of the two. If a satisfactory restructure and payment arrangement cannot be reached, the loan may be referred to legal counsel for foreclosure.

As of December 31, 2012, there was one commercial relationship with a carrying value \$4.3 million that was considered a TDR due to the nature of the concessions granted to the borrower. We have established no impairment reserve for the relationship in light of the value of underlying collateral and management's recovery expectations. The balances of the underlying loans are included in non-performing loans. For this relationship, we renegotiated certain terms of their loans in 2010. The significant term modified was the monthly principal and interest payment amount. We agreed to forbear our rights under default provisions in the loan agreements on the condition that the borrower made monthly payments which were significantly less than those required under the terms of the original loan agreements. The customer was in compliance with the terms of the forbearance agreement which expired in March 2011. At that

time, we renewed the forbearance agreement for an additional 24 months with higher monthly payments than under the previous agreement. The borrower has paid as agreed. A loan totaling \$0.3 million, previously classified as a TDR was liquidated in the second quarter of 2012. Additional information is set forth in Note 4 to the Consolidated Financial Statements.

**Summary of Non-performing Assets
As of December 31,
(dollars in thousands)**

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
Loans past due 90 days or more and accruing:					
Commercial, financial, and agricultural	\$ 46	75	225	422	106
Real estate-commercial	-	-	413	-	121
Real estate-residential	250	660	658	290	326
Consumer and other	<u>426</u>	<u>234</u>	<u>293</u>	<u>375</u>	<u>243</u>
Total past due 90 days or more and accruing	<u>722</u>	<u>969</u>	<u>1,589</u>	<u>1,087</u>	<u>796</u>
Loans in non-accrual status:					
Commercial, financial, and agricultural	2,429	3,917	4,070	10,282	3,134
Real estate-commercial	10,116	9,078	11,032	5,656	2,617
Real estate-residential	5,225	4,212	6,141	2,609	3,018
Consumer and other	<u>-</u>	<u>100</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total non-accrual loans	<u>17,770</u>	<u>17,307</u>	<u>21,243</u>	<u>18,547</u>	<u>8,769</u>
Total non-performing loans	<u>18,492</u>	<u>18,276</u>	<u>22,832</u>	<u>19,634</u>	<u>9,565</u>
Other real estate owned:					
Commercial	1,373	2,580	1,400	2,607	639
Residential	<u>2,183</u>	<u>1,655</u>	<u>2,340</u>	<u>162</u>	<u>90</u>
Total other real estate owned	<u>3,556</u>	<u>4,235</u>	<u>3,740</u>	<u>2,769</u>	<u>729</u>
Total non-performing assets	<u>\$ 22,048</u>	<u>22,511</u>	<u>26,572</u>	<u>22,403</u>	<u>10,294</u>
Restructured real-estate debt (included in non-accrual loans)	<u>\$ 4,324</u>	<u>4,826</u>	<u>4,885</u>	<u>-</u>	<u>-</u>
Non-performing loans to total period-end loans	<u>1.28 %</u>	<u>1.42 %</u>	<u>1.90 %</u>	<u>1.70 %</u>	<u>0.88 %</u>
Non-performing assets to total period-end loans and other real estate	<u>1.52 %</u>	<u>1.75 %</u>	<u>2.21 %</u>	<u>1.94 %</u>	<u>0.95 %</u>
Allowance to non-performing loans	<u>93.65 %</u>	<u>88.07 %</u>	<u>68.48 %</u>	<u>72.49 %</u>	<u>125.37 %</u>

Loan Loss Experience and Allowance for Loan Losses

Our policy for, and the determination of the appropriate balance of, the allowance for loan losses is our most difficult, subjective, and complex accounting estimate. It is also highly uncertain, since it is merely an estimate of the inherent risk of loss in the current loan portfolio. Therefore, we consider this a critical accounting estimate. Our policy and methodology for its calculation are set forth in Note 1 to the Consolidated Financial Statements.

Changes in the allowance for loan losses may arise as a result of factors both within and outside of our direct control. For example, we may change the concentration of the loan portfolio to a particular industry, a particular loan type -- commercial, residential, consumer -- or a particular geography in our market area. These changes may increase or decrease the level of allowance necessary to reflect probable incurred losses within the portfolio. The effect of the economy, including resulting changes in the value of collateral securing loans, are outside of our control, but can have significant impact on the allowance for loan losses. Generally, a declining economy will negatively impact the ability of borrowers to repay loans in a timely manner and can also negatively impact collateral values. These factors cause probable losses within the portfolio to increase, resulting in the need for a higher allowance for loan losses.

The following table summarizes the changes in the allowance for loan losses for each of the last five years.

Summary of Changes in the Allowance for Loan Losses
As of and for the years ended December 31,
(dollars in thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
Balance at beginning of year	\$ 16,095	15,635	14,232	11,992	9,679
Provision charged to operations	4,300	3,775	6,150	4,345	3,805
Charge-offs:					
Commercial, financial and agricultural	(907)	(2,082)	(2,957)	(1,063)	(1,008)
Real estate-commercial	(746)	(263)	(678)	(327)	(28)
Real estate-residential	(721)	(355)	(286)	(10)	-
Consumer and other	(1,829)	(1,863)	(2,077)	(1,564)	(1,094)
	<u>(4,203)</u>	<u>(4,563)</u>	<u>(5,998)</u>	<u>(2,964)</u>	<u>(2,130)</u>
Recoveries:					
Commercial, financial and agricultural	168	153	243	216	54
Real estate-commercial	3	-	47	5	90
Real estate-residential	65	151	50	21	28
Consumer and other	889	944	911	617	466
	<u>1,125</u>	<u>1,248</u>	<u>1,251</u>	<u>859</u>	<u>638</u>
Net charge-offs:	<u>(3,078)</u>	<u>(3,315)</u>	<u>(4,747)</u>	<u>(2,105)</u>	<u>(1,492)</u>
Balance at end of year	\$ <u>17,317</u>	<u>16,095</u>	<u>15,635</u>	<u>14,232</u>	<u>11,992</u>
Net charge-offs to average loans	<u>0.23 %</u>	<u>0.28 %</u>	<u>0.41 %</u>	<u>0.19 %</u>	<u>0.15 %</u>
Allowance to total loans	<u>1.19 %</u>	<u>1.25 %</u>	<u>1.30 %</u>	<u>1.23 %</u>	<u>1.11 %</u>

The allowance for loan losses was \$17.3 million at December 31, 2012, up from \$16.1 million at December 31, 2011. We consider the allowance for loan losses at December 31, 2012 to be at a level adequate to cover probable and inherent losses in the loan portfolio. Growth in the allowance for loans losses has been driven by a combination of general growth in the overall loan portfolio and the provision for loan losses associated with impaired loans, which were not already included in the pool-based allowance calculation. Net charge-offs to average loans decreased in 2012, continuing the downward trend from last year. The largest dollar amounts of net charge-offs had been from commercial-related loans, but these have decreased due to improvements in the economy. Consumer net charge-offs are generally stable in dollar terms, despite the increased portfolio. On the other hand we are experiencing higher net charge-offs on residential-related loans. The losses are occurring in loans to borrowers with sub-660 credit scores, and which were generally originated prior to 2008. Looking to 2013, we expect net charge-offs to stabilize around the 25 basis point level.

At December 31, 2012 we identified a total of 94 loans totaling \$17.8 million that were considered impaired. Of these, 5, with a balance of \$1.2 million outstanding, had specific reserves associated with them amounting to \$0.6 million. These reserves are included in the total allowance for loan losses. One loan relationship accounted for about half of the balance of impaired loans and two-thirds of the related allowance associated with impaired loans. The decrease in both the amount of impaired loans and the related reserve is due to improvements in and payoffs of formerly impaired loans.

The specific reserve associated with impaired and other loans was partially funded by the existing pool-based reserves. As more fully described in the Notes to the 2012 Consolidated Financial Statements, the allowance is a combination of both specific and general reserve pool-based components. Internally classified loans not considered impaired are included in a pool calculation. If a loan become impaired and a specific impairment reserve is deemed necessary, a portion of the allowance becomes allocated for the specific reserve, and the total allowance is then adjusted upward or downward as necessary through the provision for loan losses. The pool-based reserve is then recalculated to determine whether additional provision is necessary on the remaining portfolio as part of the regular allowance estimation process.

As noted, we are seeing improvements in the economy. Our local employment picture is generally faring better than the rest of the state, but is still relatively weak, just returning to a pre-recession state. According to the New York State Department of Labor as of December 31, 2012, the Rochester MSA had an unemployment rate of 8.0%, compared to New York State's of 8.2%, and the United States at 7.6%. While the nation's unemployment rate declined, both New York's and the Rochester MSA's increased, which is likely a result of more laborers seeking to re-enter the workforce.

Noting the above improved economic conditions, and the changing mix in our portfolios, we have increased the dollar amount of allowance provided for the consumer portfolio and the residential portfolio, while decreasing the allowance for the commercial portfolio.

The dollar amount in the mortgage portfolio has increased due mostly to the portfolios' balance increases, but also due to higher year-over-year nonaccrual balances. The dollar amount in the commercial portfolio has fallen recognizing its declining percentage of the entire loan portfolio, overall improvement in credit quality, and an improved business climate.

The following table presents an allocation of the allowance for loan losses and the percentage of loans in each category to total gross loans at year end for each of the last five years. In addition to an allocation for specific problem loans, each category includes a portion of the general allowance for loan losses based upon loans outstanding, credit risk and historical charge-offs. The unallocated portion of the allowance is not specifically associated with a loan category, but represents the portion of the allowance for which we have less precise loan data; it represents our estimate, based on our judgment, decades of lending experience, and total portfolio considerations. Notwithstanding the following allocation, the entire allowance for loan losses is available to absorb charge-offs in any category of loans.

Allocation of Allowance for Loan Loss and Categorical Percentage of Loan Types

	As of December 31,									
	2012		2011		2010		2009		2008	
	\$ ⁽¹⁾	% ⁽²⁾	\$ ⁽¹⁾	% ⁽²⁾	\$ ⁽¹⁾	% ⁽²⁾	\$ ⁽¹⁾	% ⁽²⁾	\$ ⁽¹⁾	% ⁽²⁾
Commercial ⁽³⁾	5,098	51.0	7,387	51.8	7,735	54.0	7,536	55.9	\$ 5,689	55.0
Residential	3,108	26.7	2,307	27.9	1,867	27.5	1,402	26.2	1,383	26.7
Consumer	7,670	22.3	5,755	20.3	5,351	18.5	4,499	17.9	3,749	18.3
Unallocated	1,441	-	646	-	682	-	795	-	1,171	-
	<u>17,317</u>	<u>100.0</u>	<u>16,095</u>	<u>100.0</u>	<u>15,635</u>	<u>100.0</u>	<u>14,232</u>	<u>100.0</u>	<u>\$ 11,992</u>	<u>100.0</u>

⁽¹⁾ Amount of allowance for loan losses

⁽²⁾ Percent of loans in each category to total loans

⁽³⁾ Includes commercial, financial, agricultural, and commercial real estate

In December 2012, the Financial Accounting Standard Board (FASB) issued a proposed Accounting Standards Update (ASU) to Credit Losses Subtopic 825-15. According to the FASB, the main objective in developing this proposal is to provide financial statement users with more decision-useful information about the expected credit losses on financial assets and other commitments to extend credit held by a reporting entity at each reporting date. This objective would be achieved by replacing the current impairment model, which reflects incurred credit events, with a model that recognizes expected credit risks and by requiring consideration of a broader range of reasonable and supportable information to inform credit loss estimates. These proposed amendments also would reduce complexity by replacing the numerous existing impairment models in current U.S. GAAP with a consistent measurement approach.

The proposed amendments would require an entity to impair its existing financial assets on the basis of the current estimate of contractual cash flows not expected to be collected on financial assets held at the reporting date. This impairment would be reflected as an allowance for expected credit losses. The proposed amendments would remove the existing —"probable" threshold in U.S. GAAP for recognizing credit losses and broaden the range of information that must be considered in measuring the allowance for expected credit losses. More specifically, the estimate of expected credit losses would be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the assets' remaining contractual cash flows. An estimate of expected credit losses would always reflect both the possibility that a credit loss results and the possibility that no credit loss results. Accordingly, the proposed amendments would prohibit an entity from estimating expected credit losses solely on the basis of the most likely outcome (that is, the statistical mode).

As a result of the proposed amendments, financial assets carried at amortized cost less an allowance would reflect the current estimate of the cash flows expected to be collected at the reporting date, and the income statement would reflect credit deterioration (or improvement) that has taken place during the period. For financial assets measured at fair value with changes in fair value recognized through other comprehensive income, the balance sheet would reflect the fair value, but the income statement would reflect credit deterioration (or improvement) that has taken place during the period. An entity, however, may choose to not recognize expected credit losses on financial assets measured at fair value, with changes in fair value recognized through other comprehensive income, if both (1) the fair value of the financial asset is greater than (or equal to) the amortized cost basis; and (2) expected credit losses on the financial asset are insignificant.

We have not yet begun to evaluate the potential impact of this proposal. However, if implemented as proposed, it might be possible that a higher allowance for loan losses would result, since losses would be recognized on an "expected" model, which takes into account the future in contrast to the current "incurred" model, which anticipates losses already incurred. Additionally we would need to consider the changes to and accounting for expected losses on investment securities.

Funding sources - Deposits and Borrowings

Our principal sources for funding assets are deposits and borrowings. Set forth below, and in Notes 7, 8 and 9 of the Consolidated Financial Statements is more detailed information about deposits and borrowings at period ends and during the year.

The following tables summarize the average deposits and average rates paid during each of the three years presented.

Average Deposits and Rates Paid For the Years Ended December 31, (dollars in thousands)

	2012		2011		2010	
	Amount	Rate	Amount	Rate	Amount	Rate
Non-interest-bearing demand	\$ 252,751	- %	\$ 207,551	- %	\$ 187,957	- %
Interest-bearing demand	179,974	0.06	155,688	0.09	139,158	0.18
Savings and money market	786,196	0.21	692,271	0.26	637,215	0.36
Time	386,115	1.01	449,404	1.53	476,486	2.00
	<u>\$ 1,605,036</u>	<u>0.35 %</u>	<u>\$ 1,504,914</u>	<u>0.59 %</u>	<u>\$ 1,440,816</u>	<u>0.84 %</u>

The following table sets forth time deposits of \$100,000 or greater classified by the time remaining until maturity which were on deposit as of December 31, 2012 (dollars in thousands).

3 months or less	\$ 34,499
4 through 6 months	22,696
7 through 12 months	45,662
Over 12 months	54,732
	<u>\$ 157,589</u>

Total deposits at December 31, 2012, were \$1,663.0 million and were up \$116.4 million from December 31, 2011. Retail and commercial account deposits grew \$117.8 million or 8.8%, due mainly to the continued success of our products, services, and brand, as well as a continued flight-to-safety of depositors toward strong community banks. Municipal deposits fell a modest \$1.4 million. Time deposits were the only category that showed a year-over-year decline. In this low rate environment, depositors are reluctant to invest in CD's for long periods. As a result they reduce both the amount they place in time deposits and the maturity terms.

Substantially all of the retail and commercial deposit growth occurred in Monroe County, while substantially all of the municipal deposit reduction came in Ontario County, where we have a relatively larger long-term municipal deposit base of customers. For 2013, we anticipate retail and commercial deposits to grow about 5% and municipal deposits to climb 3% from 2012. As in 2012, we expect the bulk of the deposit growth to come from Monroe County where we have opened new banking offices and our current market penetration is lower.

With our high level of federal funds sold in 2012 and 2011, we found no need to borrow short-term funds during these years. At December 31, 2012 we had no overnight borrowings. Depending upon our liquidity needs, we might use short-term borrowings in 2013 from time to time, as we have in the past. Short-term borrowings from the Federal Home Loan Bank of New York and the Federal Reserve Bank of New York, collateralized by loans, are used to fund near-term liquidity needs. More information about our borrowings and borrowing capacity can be found in Notes 8 and 9 to the Consolidated Financial Statements.

As of December 31, 2012, we had no short-term or medium-term borrowings beyond the payments due for the acquisition of OBS. These amount to \$3.5 million due in November 2013, and a remaining contingent amount of \$0.8 million with no stated maturity date.

Our long-term borrowings are in the form of junior subordinated debentures. In 2007, we issued \$20.6 million of fixed-to-floating-rate junior subordinated debentures and paid off a similar amount of floating rate debentures. In 2006, we issued \$30.9 million of floating rate junior subordinated debentures. The terms of these borrowings are more fully described in Note 9 to the Consolidated Financial Statements. Also in Note 9, you will find a discussion and details of interest rate swap agreements used to modify the interest rate of these debentures from floating rate to fixed rate.

Liquidity

Liquidity can be considered the lifeblood of banking. Our Board of Directors has set general liquidity guidelines for management to meet, which can be summarized as: the ability to generate adequate amounts of cash to meet the demand from depositors who wish to withdraw funds, borrowers who require funds, and capital expansion. Liquidity is produced by cash flows from our operating, investing, and financing activities.

Liquidity needs generally arise from asset originations and deposit outflows. Liquidity needs can increase when asset origination (of loans and investments) exceeds net deposit inflows. Conversely, liquidity needs are reduced when the opposite occurs. In these instances, the needs are funded through short-term borrowings, while excess liquidity is sold into the Federal Funds market.

Our principal source of day-to-day liquidity is through wholesale, secured borrowing lines from the Federal Home Loan Bank of New York (FHLB) and the Federal Reserve Bank of New York (FRB), details of which are set out in Note 8 to the Consolidated Financial Statements. During 2012, credit available to us under these lines increased by \$135.9 million to \$695.1 million at December 31, 2012, due partially to growth in the loan portfolios we pledge as collateral, and the addition of pledging commercial mortgages to the FHLB during the year. Since February 2009, we have not accessed either of these lines as deposit inflows were sufficient to provide funds for asset growth.

Secondarily, we occasionally use the liquidity source of time deposit sales in the national brokered market. We will use this source from time to time to manage both liquidity and interest rate risk as conditions may require. At December 31, 2012 we had none outstanding. It is possible we will increase the balance of brokered deposits from time to time if our internal models dictate the need for additional long-term funds at relatively attractive rates.

We measure our liquidity on a daily basis with reference to our Fed Funds and Federal Reserve Bank of New York clearing account balances. This is supplemented by a monthly Liquidity Report, which projects expected liquidity sources and uses over a twelve-month period. The results of this model provide ALCO with a near-term view of liquidity and allow us to make appropriate plans and adjustments in a comprehensive manner, consistent with short- and long-term financial goals. Our use of the model reduces the risk of short-term, unplanned liquidity crises, which can be costly to net interest income, or ultimately, impact a bank's survival.

As measured using the Consolidated Statement of Cash Flows, for the year ended December 31, 2012, we used \$35.6 million in net cash equivalents versus \$11.5 million in net cash and equivalents in 2011.

Net cash provided by operating activities was \$16.2 million in 2012 and \$35.3 million in 2011. Both the largest source and use of operating cash in each year were mortgage banking-related activities. These activities were about 65% higher in 2012 than in 2011. We expect 2013 operating activities to approximate levels experienced in 2012.

Cash used by investing activities in 2012 increased from 2011 to \$157.2 million from \$116.6 million 2011. Net portfolio loan originations were the largest user of cash. Net purchases of securities used little cash in 2012 as purchases nearly equaled maturities and calls, while in 2011 net purchases used \$12.3 million in cash. In 2011 we increased our portfolio to reinvest the high level of fed funds sold. Net portfolio loan originations were \$158.3 million in 2012 and \$99.4 million in 2011. The increases in both 2012 and 2011 were due to our efforts to reinvest liquid assets into higher yielding loans from fed funds sold. In 2013, we expect net loan originations to be somewhat lower than 2011's as we slow our rate of loan growth from recent years.

Cash provided by financing activities was \$105.4 million in 2012 compared to \$69.7 million in 2011. The largest source of financing funds in 2012 and 2011 was customer deposits. Repayments of term borrowings used cash in both years. For 2013, we expect financing to be provided by deposits, though we may use long-term borrowings if rates are attractive. We expect deposit growth to come from consumer and business deposits, which, are expected to come mainly from Monroe County sources.

Less material, but a part of our ongoing operations, and expected to be funded by normal operations, are liquidity uses such as lease obligations and long-term debt repayments. A summary of these required commitments is included in the table below and details can be found in Notes 8, 9, 15 and 16 to the Consolidated Financial Statements. Contingent funding commitments associated with extensions of credit to customers are set out in Note 16 to the Consolidated Financial Statements and are not included in the table below, because we are unable to determine the amount that would be drawn or its timing.

**Payment due by period
As of December 31, 2012
(dollars in thousands)**

	Total	Less Than one Year	One Year Through Three Years	After Three Years Through Five Years	More Than Five Years
Borrowings	\$ 51,547	-	-	-	51,547
Operating leases	21,316	2,465	4,737	4,598	9,516
WBI's acquisition payments	4,367	3,500	867	-	-
Cephas Capital Partners II	1,500	-	-	-	1,500
Trillium Lakefront Partners	40	40	-	-	-
Total	\$ 78,770	6,005	5,604	4,598	62,563

Total obligations are \$78.8 million at year-end 2012 compared to \$82.7 million at year-end 2011. The only significant change is WBI's commitment associated with the acquisition of OBS due to the scheduled May 2012 payment. Except for the payments set forth in the table above, we are not aware of any material commitments in 2013.

Interest Rate Risk Management

Because our largest single source of revenue is net interest income, interest rate risk management is an important function at our Company. We consider interest rate risk to be our most significant market-based risk. We realize net interest income principally from the differential or spread between the interest earned on loans, investments and other interest-earning assets and the interest paid on deposits and borrowings. Loan volumes and yields, as well as the volume of and rates on investments, deposits and borrowings, are affected by market interest rates. Additionally, because of the terms and conditions of many of our loans and deposit accounts, a change in interest rates could also affect the projected maturities of the loan portfolio and/or the deposit base, which could alter our sensitivity to future changes in interest rates.

Interest rate risk management focuses on maintaining consistent growth in net interest income within Board-approved policy limits. Considered in the evaluation, among other factors are: overall credit risk, operating income, operating costs, and available capital. Our Asset/Liability Committee (ALCO) includes the Bank's CEO, President and senior officers in various disciplines including Treasury, Finance, Commercial Lending, Retail Lending, and Sales. The Committee reports to the Board on its activities to monitor and manage interest rate risk.

Management of interest rate risk leads us to select certain techniques and instruments to utilize after considering the benefits, costs and risks associated with available alternatives. Since we do not utilize derivative financial instruments, other than interest rate swap agreements, we usually consider one or more of the following: (1) interest rates offered on products, (2) maturity terms offered on products, (3) types of products offered, and (4) products available to us in the wholesale market such as advances from the FHLB and brokered time deposits.

ALCO's principal focus is net interest income at risk. We use a net interest margin shock simulation model as one method to identify and manage our interest rate risk profile. The model measures projected net interest income "at-risk" and anticipated resulting changes in net income and economic value of equity. The model is based on expected cash flows and repricing characteristics for all financial instruments at a point in time and incorporates our market-based assumptions regarding the impact of changing interest rates on these financial instruments over a twelve-month period. We also incorporate assumptions based on the historical behavior of deposit rates and balances in relation to changes in interest rates. These assumptions are inherently uncertain and, as a result, the model cannot precisely measure net interest income or precisely predict the impact of fluctuations in interest rates on net interest income. While actual results will differ from simulated results due to timing, magnitude, and frequency of interest rate changes, as well as changes in market conditions and management strategies, this model has proven to be an important guidance tool for ALCO. The following table sets forth the results of this model for the Bank, the principal entity exposed to market risk, at December 31, 2012.

Changes in Interest Rates (basis points)	Estimated Percentage Change in Future Net Interest Income
200	-
100	(2)
No change	-
-100	-
-200	-

We measure net interest income at risk by estimating the changes in future net interest income resulting from instantaneous and sustained parallel shifts in interest rates of plus or minus 200 basis points over a twelve-month period. This provides a basis or benchmark for ALCO to manage the Company's interest rate risk profile. At December 31, 2012, a relatively small upward shock (100 basis points) would cause an estimated 2% reduction in net interest income due to our gap position (discussed below), and a larger shock would have no measurable impact as asset yields would rise considerably more than liability costs. Downward shocks would have little impact on net interest income, because rates paid are near zero, although they could be lowered somewhat, and asset yields are near our floor rates. We recognize the model only provides a benchmark, because it makes the simplifying assumptions that: (1) interest rates will move in a parallel direction with no change in the yield curve; (2) the interest rate moves will be instantaneous and sustained; and (3) there will be no change in the product mix as determined by customer demand or pricing policies by management.

A second tool used by ALCO is its proprietary cost of funds model. This model is used weekly and measures actual interest rates paid on deposits and borrowings and earned on loans and investments. This model takes into consideration current interest rates, interest rate trends, product and portfolio spreads, and projected and historical net interest income data. Using this model, we can adjust and determine the financial impact on net interest income on a more rapid basis than the net interest margin shock simulation model, which is prepared monthly.

A third method used to identify and manage our interest rate risk profile is the static gap analysis. Interest sensitivity gap ("gap") analysis measures the resulting difference between interest-earning assets and interest-bearing liabilities repricing or maturing within specific time periods. An asset-sensitive position indicates that there are more rate-sensitive assets than rate-sensitive liabilities repricing or maturing within specific time horizons. This generally implies a favorable impact on net interest income in periods of rising interest rates and a negative impact in periods of falling rates. A liability-sensitive position generally implies a negative impact on net interest income in periods of rising rates and a positive impact in periods of falling rates.

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2012. Interest-earning assets are shown based on the earlier of their contractual maturity or repricing date. Securities include the market value of available-for-sale securities, amortized cost of held-to-maturity securities, FRB and FHLB stock. Callable securities are shown at their stated maturity. Loans, without deferred costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accrual loans. All interest-bearing liabilities are shown based on the earlier of their contractual maturity or repricing date with no adjustment for decay (withdrawal) rates. Borrowings include the junior subordinated debentures. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates, or by factors controllable by us such as asset sales, it is not an absolute reflection of our potential interest rate risk profile.

The maturities set forth are based upon contractual maturities. Demand loans, overdrafts and certain time loans, the principal of which may be renewed in whole or in part, are included in the "One Year or Less" classification. Our loan policy encourages a repayment schedule to be established whenever possible for loans that do not have stated contractual maturities. The policy provides that a demand loan should mature within one year of its origination, with any renewals at the then-prevailing interest rate and with the assurance that the borrower demonstrates the ability to repay on maturity of the loan.

Interest Rate Sensitivity Gap
December 31, 2012
(dollars in thousands)

	Maturity/Repricing Period				
	Within 3 Months	4 to 12 Months	13 to 36 Months	37 to 48 Months	Over 48 Months
Interest-earning assets:					
Interest-bearing deposits	\$ 91,159	-	-	-	-
Securities	35,149	11,899	78,532	40,439	115,338
Loans	469,252	180,111	387,308	180,238	232,314
Total interest-earning assets	<u>595,560</u>	<u>192,010</u>	<u>465,840</u>	<u>220,677</u>	<u>347,652</u>
Interest-bearing liabilities:					
NOW accounts	196,478	-	-	-	-
Savings and money market	812,485	-	-	-	-
Time deposits	65,555	169,219	97,201	38,365	13
Borrowings	51,547	3,500	867	-	-
Total interest-bearing liabilities	<u>1,126,065</u>	<u>172,719</u>	<u>98,068</u>	<u>38,365</u>	<u>13</u>
Interest rate swap affecting liabilities	<u>(51,547)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>51,547</u>
Interest rate sensitivity gap	<u>\$ (478,958)</u>	<u>19,291</u>	<u>367,772</u>	<u>182,312</u>	<u>296,092</u>
Cumulative gap	<u>\$ (478,958)</u>	<u>(459,667)</u>	<u>(91,895)</u>	<u>90,417</u>	<u>386,509</u>
Cumulative gap ratio ⁽¹⁾	<u>55.4 %</u>	<u>63.1 %</u>	<u>93.2 %</u>	<u>106.5 %</u>	<u>126.9 %</u>
Cumulative gap as percent of total assets	<u>(25.4)%</u>	<u>(24.4)%</u>	<u>(4.9)%</u>	<u>4.8 %</u>	<u>20.5 %</u>

⁽¹⁾ Cumulative total interest-earning assets divided by cumulative total interest-bearing liabilities.

The table indicates that \$479.0 million more interest-bearing liabilities (than interest-earning assets) will reprice in the 0-3 month range. For the 4-12 month period, we are asset sensitive, as \$19.3 million more of interest-earning assets are repricing than interest-bearing liabilities. For the entire one-year range, we are repricing \$459.7 million more interest-bearing liabilities than assets and at 63.1% are within our gap ratio targets of 30% to 125%. We are asset sensitive at \$367.8 million for the 13-36 month range, \$182.3 million for the 37 to 48 month year range, and \$296.1 million over 48 months. For the entire portfolio range, we are asset sensitive at \$386.5 million versus asset sensitive of \$324.9 million last year, mostly reflecting the growth in non-interest-bearing liabilities.

Our product mix is such that nearly all assets and liabilities reprice or mature within five years. With such a balance sheet profile, we face interest rate risk over the short to medium term. We consider this interest rate gap manageable, as substantially all of the NOW accounts and savings balances are considered insensitive to rate changes.

The following table provides additional detail of the interest sensitivity specifically of certain commercial and industrial loans as of December 31, 2012.

Maturity and Repricing of Commercial and Industrial Loans
As of December 31, 2012
(dollars in thousands)

	One Year or Less	After One Through Five Years	After Five Years	Total
Commercial and industrial loans	\$ 167,958	\$ 39,465	\$ 6,044	\$ 213,467
Maturing or repricing after one year:				
with a fixed interest rate	\$ 1,278	39,465	6,044	46,787
with a floating or adjustable rate	\$ 166,680	-	-	166,680

Capital and Dividends

The Company and Bank are each subject to certain regulatory capital requirements. As of December 31, 2012, the Company and Bank each substantially exceeded all capital requirements to which they were subject. A full description of these requirements and applicable calculations are set out in Note 17 to the Consolidated Financial Statements.

Our goal is to maintain the Company's and Bank's categorization as "well-capitalized," and our current operating plans project the Company and Bank to remain at well-capitalized status. This will be accomplished mainly through balancing asset growth and net capital formation (net income less dividends and treasury stock purchases). We can take other steps to improve capital ratios as considered necessary, such as dividend reductions, asset sales, issuing equity securities, or issuing additional debt qualifying as regulatory capital and other means. None of these are contemplated in 2013.

On September 12, 2010, the Basel Committee on Banking Supervision released its proposal for revising capital requirements for internationally active financial institutions. These new standards are called Basel III. On June 7, 2012, the US banking regulators published their Notice of Proposed Rule Making (NPRM) to implement changes in capital rules. In two different actions, both the Federal Reserve and the Federal Deposit Insurance Corporation have proposed new capital requirements for all banks that essentially accept all recommendations from the Basel III accord. While we had anticipated some changes for community banks, we were surprised that non-international banks like us would be within the scope of much of the proposal. The proposed rule will increase required capital and change risk-weightings for many assets. The proposed rule will apply across all institutions regardless of their systematic risk profile. While the proposed rule was to be effective as of January 1, 2013, full compliance with most aspects would not be required until January 1, 2019. In late 2012, the regulators indefinitely delayed implementation of the proposal. We have not determined the financial impact of the proposed rule on us, because of the regulatory uncertainty and the deferred implementation.

The key features that generally relate to banks like ours are:

- New minimum regulatory capital ratio requirements
 - A newly-introduced "common equity" tier 1 ratio of 4.5%,
 - Tier 1 capital ratio of 6% (increased from the current requirement of 4%),
 - Total capital ratio of 8% of risk-weighted assets (unchanged from the current requirement), and
 - Tier 1 leverage ratio of 4%.
- New capital conservation buffer: To avoid restrictions on capital distributions (e.g. distributing dividends) and discretionary bonus payments to executive officers, a bank will be required to hold an additional buffer of common equity Tier 1 capital in an amount above 2.5% of total risk-weighted assets in addition to the minimum common equity Tier 1, Tier 1, and total risk-based capital ratios.
- Capital is redefined, what is included in Tier 1 capital will change:
 - Cumulative preferred and trust preferred instruments would be excluded from Tier 1 capital.
 - Regulatory capital deductions would be stricter than those currently required. Examples of the more stringent requirements for common equity Tier 1 capital are:
 - Unrealized gains and losses on all available-for-sale securities and gains and losses associated with certain cash flow hedges will now flow through to common equity Tier 1 capital. Currently, these gains and losses are neutralized when calculating regulatory capital;
 - Goodwill and net defined benefit pension plan assets will be deducted;

- Deferred tax assets (DTAs) arising from operating losses and tax credit carry forwards will be deducted;
 - Mortgage servicing assets, deferred tax assets arising from temporary differences that an organization could not realize through net operating loss carry backs, and the common stock of unconsolidated financial institutions each would be individually limited to 10% of common equity Tier 1 capital, and, in the aggregate, to 15% of common equity Tier 1 capital; and
 - The amount of minority interests permitted in capital would be more limited.
- Asset risk-weighting changed: The most significant changes to the calculation of risk-weighted assets are:
 - The treatment of exposures to the U.S. government, U.S. public sector entities (such as states and municipalities), U.S. government-sponsored entities, and U.S. depository institutions would be unchanged from the current rules. However, the risk weight for an exposure to a foreign bank or public-sector entity (PSE), such as a state or municipality, would be assigned based on the rating of its home country.
 - Residential mortgage exposures would be assigned to a range of risk weight categories (between 35 and 200%) based upon the loan-to-value (LTV) ratio of the mortgage and certain mortgage product features. Currently, most residential mortgages are assigned a 50% risk weight despite the broad range of risk profiles associated with mortgage exposures.
 - Certain commercial real estate loans are assigned a 150% risk weight.
 - Nonaccrual loans and loans greater than 90 days past due are assigned a 150% risk weight.

We expect capital to increase in 2013 by a greater amount than in 2012 due to a combination of higher net income and lower dividends. In December 2012, with uncertainty caused by the so-called “fiscal cliff”, we accelerated a \$1.63 per share dividend that would have been paid in February 2013. So, per share dividends in 2013 will reflect only the semi-annual dividend paid in the summer, while 2012 included both semi-annual dividends and the December 2012 dividend. Total dividends thus were \$4.74 per outstanding common share or \$9.0 million in 2012 and \$5.4 million or \$2.87 per outstanding common share in 2011. Payment of dividends by the Bank to the Company is limited in certain circumstances, which are discussed in Note 11 to the Consolidated Financial Statements. You can find historical dividend information in the Common Stock Data section below and in the Financial Highlights. While we cannot provide assurance that the amount and timing of dividends paid in recent years will continue, we have no knowledge of current activities that would require us to reduce dividends.

From time to time the Company purchases shares for treasury and re-issues shares from treasury. In 2012, activity was much higher than in recent years, and generally related to stock option exercises. This was due to employee retirements and tax planning activities of option holders in connection with the “fiscal cliff” uncertainty. We expect common shares to be available in the open market resulting from stock option exercises and shareholders' sales. From time to time, we may buy shares into treasury, from which we fund our ESOP and other employee awards, including the annual Arthur S. Hamlin Award. In 2013, we expect to purchase more shares into treasury for past stock option exercises than in recent years due to 2012's higher activity.

Off Balance Sheet Arrangements

We offer certain financial products which are not recorded on our balance sheet because actual funds have not been extended. These are in the form of standby letters of credit and loan commitments. We have enumerated these in Note 16 to the Consolidated Financial Statements. At December 31, 2012, there were no material commitments to extend credit which represent unusual risks outside of our normal course of business.

Legislative and Regulatory Matters

On July 21, 2010, the President signed into law *The Dodd-Frank Wall Street Reform and Consumer Protection Act* (“Financial Reform Act”). The Financial Reform Act significantly alters financial regulation in the United States by creating new regulators, regulating new markets, bringing new firms into the regulatory arena, and providing new rulemaking and enforcement powers to regulators. The Financial Reform Act is intended to address specific issues that contributed to the financial crisis and is heavily remedial in nature. Many of the provisions in the Act are applicable to larger institutions (greater than \$10 billion in assets, which does not include us). A summary of the Financial Reform Act's principal provisions that have impacted or may potentially impact the Company follows.

The Financial Reform Act created the Financial Stability Oversight Council with the primary obligation to identify, monitor, and assist in the management of systemic risk that may pose a threat to the country's financial system. Included in its responsibilities is a requirement to review and, at its option, submit comments as appropriate to any standard-setting body (such as the Financial Accounting Standards Board [FASB]) with respect to existing or proposed accounting principles, standards or procedures. Though this responsibility may not directly impact the Company, the Council's review and commentary on accounting matters may result in more consideration by standard-setters of the volatility created by some of its current and proposed standards. We hope the Council's activities will bring restraint to standard setters and temper ineffective proposals such as mark-to-market accounting for all financial instruments.

The Act permanently implemented FDIC insurance coverage for all deposit accounts up to \$250,000. Furthermore, the insurance premium assessment base was revised from all domestic deposits to the average of total assets less tangible equity. The minimum reserve ratio of the deposit insurance fund was increased from 1.15% to 1.35%, with the increase to be covered by assessments on

insured institutions with assets over \$10 billion until the new reserve ratio is reached. We discussed the impact of this provision under “Operating Expenses” above, but in summary, this provision has significantly reduced the Company’s deposit insurance premiums.

The Act creates the Consumer Financial Protection Bureau (CFPB). It has an independent budget and is housed in the Federal Reserve Board, but not subject to its jurisdiction. The CFPB has rulemaking authority to promulgate regulations regarding consumer financial products and services offered by all banks and thrifts, their affiliates and many non-bank financial services firms. We cannot determine what the impact the CFPB’s rules and regulations might have on the Company, its product offerings, its customers’ ability to purchase products to meet their specific needs, or the Company’s general business practices, but they are likely to be significant given the CFPB’s broad powers.

The so-called “Durbin Amendment” requires the Federal Reserve Board to adopt regulations limiting interchange fees that can be charged in an electronic debit card transaction to the “reasonable and proportionate” costs related to the incremental cost of the transaction. Banks under \$10 billion in assets are exempt, which would include the Company. Final rules were implemented in 2011. While the rules are not designed to negatively impact smaller banks, and to date we have not experienced any detrimental effects. The Company contracts with large debit card processors with which we have relatively weak bargaining power. It is possible these processors, as a result of the Act, will earn lower revenues, leaving less revenue per transaction for the Company.

The Act has changed oversight authority for the prudential regulation of our Company so both the Bank and its holding company will be regulated by the Office of the Comptroller of the Currency (OCC), because the Company has less than \$50 billion in assets. Formerly the Bank was regulated by the OCC and the holding company was regulated by the Federal Reserve Board.

The Act significantly changes the regulatory structure of the mortgage lending business, but, in effect, has codified the prudent and customer-focused activities the Company has always pursued. For example, the Act provides that a creditor must make a reasonable and good faith determination of a consumer’s ability to repay before making a residential mortgage loan. The determination must be based on verified and documented information and must take into account all applicable taxes, insurance and assessments. While not previously enforced by regulation, this has been our consistent practice.

On the other hand, the Act does add substantial burdens to the Company by, subject to certain exemptions, requiring the establishment of an escrow account in connection with a closed-end consumer credit transaction secured by a first lien on a consumer’s principal dwelling for the payment of taxes and hazard insurance and, if applicable, flood insurance, mortgage insurance, ground rents and any other required periodic payments or premiums with respect to the property or the loan terms. The Company has not historically escrowed such payments. We provide financial advice and a savings product for customers to self-escrow, believing that customers are the best stewards and managers of their personal cash flow sources and uses, and government is ill-suited to dictate how much and when individual consumers should save to meet their financial obligations. That notwithstanding, we are able to satisfy the escrow requirements as proposed.

The Act also modified the calculation for a loan to be subject to “high-cost-loan” status under the Home Ownership and Equity Protection Act (HOEPA) by requiring the Annual Percentage Rate (APR) to be compared to the average prime offer rate for a comparable transaction and not the rate on U.S. Treasury securities having a comparable maturity. The points and fees trigger is lowered, and a prepayment fee trigger is added. We believe any comparison is a flawed policy, because low balance loans, those most beneficial to first-time homeowners, would carry an interest rate unprofitable to the Company. Principally the methodology ignores that originating a loan, no matter what its balance, has certain fixed costs, and these costs when spread over a smaller balance result in a higher effective interest rate.

Recent Accounting Standards to be implemented in Future Periods

The following presents a summary of Accounting Standards Updates (ASU’s), exclusive of technical correction ASU’s that will be subject to implementation in future periods.

ASU 2011-11 Disclosures about Offsetting Assets and Liabilities, issued December 2011, and ASU 2013-01 Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, issued January 2013. The amendments in these Updates require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments are intended to bring closer convergence of US GAAP with International Financial Reporting Standards (IFRS). The ASU applies to derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amendments are effective for us beginning in 2013. Because we do not currently engage in these types of transactions, we do not anticipate any material impact to our financial statements.

ASU 2012-02 Testing Indefinite-Lived Intangible Assets for Impairment, issued July 2012. The amendments in this update permit an entity first to assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test in accordance with Subtopic 350-30, Intangibles—Goodwill and Other—General Intangibles Other than Goodwill. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Previous guidance in Subtopic 350-30 required an entity to test indefinite-lived intangible assets for

impairment, on at least an annual basis, by comparing the fair value of the asset with its carrying amount. If the carrying amount of the intangible asset exceeds its fair value, an entity should recognize an impairment loss in the amount of that excess. In accordance with the amendments in this Update, an entity will have an option not to calculate annually the fair value of an indefinite-lived intangible asset if the entity determines that it is not more likely than not that the asset is impaired. Permitting an entity to assess qualitative factors when testing indefinite-lived intangible assets for impairment results in guidance that is similar to the goodwill impairment testing guidance in Update 2011-08. This update is effective for us beginning in 2013, although earlier adoption is permitted. Since we have recorded no indefinite-lived intangible assets, implementation of this update will have no impact on the financial condition or results of operations of the Company.

ASU 2013-02 Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, issued February 2013. The amendments in this Update seek to improve the reporting of reclassifications out of accumulated other comprehensive income by requiring an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles (GAAP) to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. This would be the case when a portion of the amount reclassified out of accumulated other comprehensive income is reclassified to a balance sheet account (for example, inventory) instead of directly to income or expense in the same reporting period. The amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. The amendments are effective for us beginning in 2013, and will result in additional disclosures, but no change in accounting for the relevant transactions.

Summary Quarterly Financial Data

In the tables below, we present summary quarterly financial results for each of the quarters in the years ended December 31, 2012, and 2011. The sum of each quarter's earnings-per-share data may differ from the full year's results due to rounding (in thousands except share data).

<u>2012 Quarters:</u>	<u>1st</u>	<u>2nd</u>	<u>3rd</u>	<u>4th</u>
Net interest income	\$ 16,193	\$ 16,038	\$ 16,357	\$ 17,015
Provision for loan losses	(1,150)	(1,150)	(1,500)	(500)
Non-interest income	8,182	8,758	8,910	9,273
Operating expenses	(18,144)	(17,243)	(16,692)	(17,296)
Income taxes	(1,510)	(1,955)	(2,138)	(2,831)
Noncontrolling interests	(42)	108	51	103
Net income	\$ 3,529	\$ 4,556	\$ 4,988	\$ 5,764
Basic earnings per share	\$ 1.87	\$ 2.41	\$ 2.64	\$ 3.06
Diluted earnings per share	\$ 1.83	\$ 2.36	\$ 2.58	\$ 2.99
<u>2011 Quarters:</u>				
Net interest income	\$ 14,823	\$ 15,145	\$ 15,310	\$ 16,195
Provision for loan losses	(750)	(140)	(1,500)	(1,385)
Non-interest income	7,192	6,919	7,338	7,359
Operating expenses	(15,321)	(14,835)	(13,961)	(20,286)
Income taxes	(1,605)	(2,045)	(2,162)	(366)
Noncontrolling interests	-	-	-	387
Net income	\$ 4,339	\$ 5,044	\$ 5,025	\$ 1,904
Basic earnings per share	\$ 2.30	\$ 2.67	\$ 2.66	\$ 1.01
Diluted earnings per share	\$ 2.26	\$ 2.63	\$ 2.61	\$ 0.99

The fourth quarter of 2012's results were positively impacted by growth in both net interest income and non-interest income, and lower provision for loan losses due to credit improvements. This was offset by higher operating expenses associated with higher bonus accruals based upon full-year earnings and general expenses associated with growth. The fourth quarter of 2011's results were positively impacted by higher net interest income due to loan portfolio growth, offset by significantly higher operating expenses driven by higher incentive stock plan accruals associated with the increase in the price of the Company's stock, acquisition costs of OBS, and higher intangible amortization.

Our Common Stock

At December 31, 2012, we had approximately 1,500 shareholders of record. Information about beneficial ownership of the Company's stock by directors and certain officers is set forth in the Company's Proxy Statement for the 2013 Annual Meeting of Shareholders. Market value and dividend information is set forth in table below. The Company currently pays a semi-annual dividend in February and August (exclusive of the acceleration of February 2013's dividend to December 2012). We expect to continue to pay cash dividends to our stockholders for the foreseeable future.

The following table sets forth, for the monthly period indicated in 2012, the total number of shares purchased and the price paid per share by The Canandaigua National Bank and Trust Company (Bank) for the Arthur S. Hamlin Award, the Canandaigua National Corporation Employee Stock Ownership Plan (ESOP) and the Canandaigua National Corporation for treasury. Each of these entities is considered an affiliated purchaser of the Company under Item 703 of Regulation S-K. Shares repurchased by Company are not part of a publicly announced plan or program. The Bank, ESOP, and Company purchase prices per share were determined based on the most recent price established at the sealed-bid auction immediately preceding the purchase. Purchases occur on an ad-hoc basis when shares become available in the marketplace and the Company is interested in purchasing these shares for the corporate purposes discussed above. Sales occur when corporate needs require the use of shares and there are none available in the market at the time.

Purchases and Sales of Equity Securities for the Year Ended December 31, 2012

<u>Date</u>	<u>Total Shares Purchased (Sold) (#)</u>	<u>Average Price Per Share (\$)</u>	<u>Purpose</u>
April	100	\$ 152.56	Treasury
June	(243)	\$ 153.53	Compensation
June	1,336	\$ 154.86	Treasury
July	222	\$ 149.24	Treasury
November	623	\$ 149.75	Treasury
December	7,434	\$ 147.07	Treasury
December	(21)	\$ 147.07	Compensation
Total purchases	<u>9,715</u>		
Total sales	<u>(264)</u>		

While the Company's stock is not actively traded, from time to time, shareholders sell shares to interested persons in sealed-bid public auctions administered by the Bank's Trust Department at the request of selling shareholders. Our stock is not listed with a national securities exchange. Due to the limited number of transactions, the quarterly high, low and weighted average sale prices may not be indicative of the actual market value of the Company's stock. The following table sets forth a summary of transactions by selling shareholders and bidders in the Company's common stock during each period for transactions that were administered by the Bank's Trust Department. Also included are the book value at quarter end, and semi-annual dividends paid per share since the first quarter of 2010. The \$1.63 per share dividend paid in December 2012 was accelerated from the semi-annual dividend payment that would have been paid in February 2013.

	<u># Shares Sold</u>	<u>Quarterly Average Sales Price</u>	<u>Quarterly High Sales Price</u>	<u>Quarterly Low Sales Price</u>	<u>Book Value</u>	<u>Dividend Paid</u>
<u>2012</u>						
4 th Quarter	5,034	\$ 145.51	\$ 170.00	\$ 125.00	\$ 74.64	\$ 1.63
3 rd Quarter	2,748	\$ 148.70	\$ 190.00	\$ 138.00	\$ 73.42	\$ 1.61
2 nd Quarter	10,635	\$ 152.17	\$ 185.00	\$ 137.51	\$ 72.57	-
1 st Quarter	1,926	\$ 147.48	\$ 165.78	\$ 141.93	\$ 71.00	\$ 1.50
<u>2011</u>						
4 th Quarter	1,492	\$ 129.22	\$ 150.00	\$ 123.75	\$ 71.95	-
3 rd Quarter	3,216	\$ 111.34	\$ 118.13	\$ 107.50	\$ 69.55	\$ 1.44
2 nd Quarter	3,036	\$ 103.87	\$ 110.00	\$ 102.50	\$ 69.34	-
1 st Quarter	2,948	\$ 99.89	\$ 107.21	\$ 98.69	\$ 66.71	\$ 1.43
<u>2010</u>						
4 th Quarter	2,528	\$ 95.85	\$ 102.90	\$ 93.91	\$ 65.54	-
3 rd Quarter	3,172	\$ 91.89	\$ 100.00	\$ 90.03	\$ 63.55	\$ 1.43
2 nd Quarter	3,200	\$ 88.44	\$ 92.50	\$ 87.53	\$ 62.99	-
1 st Quarter	3,040	\$ 85.37	\$ 91.75	\$ 83.75	\$ 59.93	\$ 1.29

Although the Company's common stock is not listed with a national securities exchange, it trades sporadically on the Over-the-Counter Bulletin Board System under the symbol CNND or CNND.OB. The following table sets forth a summary of information about these trades. Due to the limited number of transactions, the quarterly high, low and weighted average bid/ask prices may not be indicative of the actual market value of the Company's stock.

The OTC Bulletin Board[®] (OTCBB) is a regulated quotation service that displays real-time quotes, last-sale prices, and volume information in over-the-counter (OTC) equity securities. An OTC equity security generally is any equity that is not listed or traded on NASDAQ[®] or a national securities exchange. The OTCBB is a quotation medium for subscribing members, not an issuer listing service, and should not be confused with The NASDAQ Stock MarketSM. Investors must contact a broker/dealer to trade OTCBB securities. Investors do not have direct access to the OTCBB service. The Securities and Exchange Commission's (SEC's) Order-Handling Rules which apply to NASDAQ-listed securities do not apply to OTCBB securities. The OTCBB market quotations set forth below reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	<u># Shares</u>	<u>Quarterly Average Bid/Ask Price</u>	<u>Quarterly High Bid/Ask Price</u>	<u>Quarterly Low Bid/Ask Price</u>
<u>2012</u>				
4th Quarter	1,963	\$ 123.24	\$ 130.00	\$ 115.00
3rd Quarter	3,055	\$ 130.97	\$ 200.01	\$ 120.00
2nd Quarter	1,897	\$ 112.01	\$ 135.00	\$ 105.00
1st Quarter	5,603	\$ 93.56	\$ 105.00	\$ 87.50
<u>2011</u>				
4th Quarter	7,375	\$ 97.00	\$ 160.00	\$ 79.64
3rd Quarter	2,456	\$ 97.70	\$ 105.00	\$ 87.50
2nd Quarter	636	\$ 90.12	\$ 93.75	\$ 86.50
1st Quarter	2,536	\$ 85.26	\$ 88.50	\$ 83.75
<u>2010</u>				
4th Quarter	2,544	\$ 81.82	\$ 90.00	\$ 78.25
3rd Quarter	3,256	\$ 75.55	\$ 78.75	\$ 70.25
2nd Quarter	748	\$ 78.01	\$ 80.00	\$ 75.25
1st Quarter	1,808	\$ 77.42	\$ 82.50	\$ 70.00

Management Report on the Effectiveness of Internal Controls over Financial Reporting

Management of Canandaigua National Corporation (the Company) is responsible for the preparation, integrity, and fair presentation of its published financial statements and all other information presented in its annual report. The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles and, as such, include amounts based on informed judgments, assumptions and estimates made by management.

Management is also responsible for establishing and maintaining adequate and effective internal control over financial reporting presented in conformity with both U.S. generally accepted accounting principles and the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report instructions) and as defined in Exchange Act Rules 13a-15(f). This internal control contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in any internal control, including the possibility of human error and the circumvention of overriding controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Management assessed the Company's internal control over financial reporting presented in conformity with both U.S. generally accepted accounting principles and call report instructions as of December 31, 2012. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2012, the Company maintained effective internal control over financial reporting presented in conformity with both U.S. generally accepted accounting principles and call report instructions.

KPMG LLP, an independent registered public accounting firm, has audited the consolidated financial statements included in the annual report and the effectiveness of the Company's internal control over financial reporting as of December 31, 2012.

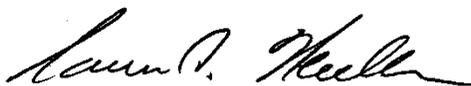
Management is also responsible for complying with federal laws and regulations concerning dividend restrictions and loans to insiders, designated by the FDIC as safety and soundness laws and regulations.

Management assessed compliance with the aforementioned designated safety and soundness laws and regulations. Based on this assessment, management believes that the Company complied, in all material respects, with such designated laws and regulations relating to safety and soundness during the year ended December 31, 2012.

February 21, 2013



George W. Hamlin, IV
Chairman and Chief Executive Officer



Lawrence A. Heilbronner
Executive Vice President and Chief Financial Officer

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Canandaigua National Corporation:

We have audited Canandaigua National Corporation's (the Company) internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on the Effectiveness of Internal Controls over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because management's assessment and our audit were conducted to also meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of the Company's internal control over financial reporting included controls over the preparation of the schedules equivalent to the basic financial statements in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C). A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Canandaigua National Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We do not express an opinion or any other form of assurance on management's statement referring to compliance with laws and regulations.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Canandaigua National Corporation and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012, and our report dated February 21, 2013 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Rochester, New York
February 21, 2013

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Canandaigua National Corporation:

We have audited the accompanying consolidated balance sheets of Canandaigua National Corporation and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Canandaigua National Corporation and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Canandaigua National Corporation's internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 21, 2013 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

KPMG LLP

Rochester, New York
February 21, 2013

CANANDAIGUA NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

December 31, 2012 and December 31, 2011
(dollars in thousands, except per share data)

	2012	2011
Assets		
Cash and due from banks	\$ 47,748	52,715
Interest-bearing deposits with other financial institutions	8,767	6,490
Federal funds sold	34,644	67,535
Securities:		
- Available for sale, at fair value	102,774	114,258
- Held-to-maturity (fair value of \$180,015 in 2012 and \$172,517 in 2011)	175,850	167,225
Loans - net	1,441,455	1,276,426
Premises and equipment – net	15,119	16,101
Accrued interest receivable	6,596	6,627
Federal Home Loan Bank stock and Federal Reserve Bank stock	2,733	2,656
Goodwill	15,570	15,570
Intangible assets – net	6,233	7,737
Prepaid FDIC assessment	2,824	3,905
Other assets	26,715	23,519
Total Assets	\$ 1,887,028	1,760,764
Liabilities and Stockholders' Equity		
Deposits:		
Demand		
Non-interest bearing	\$ 283,547	227,284
Interest bearing	196,478	175,409
Savings and money market	812,485	745,713
Time	370,353	398,204
Total deposits	1,662,863	1,546,610
Borrowings	4,296	6,836
Junior subordinated debentures	51,547	51,547
Accrued interest payable and other liabilities	23,959	20,533
Total Liabilities	1,742,665	1,625,526
Canandaigua National Corporation stockholders' equity:		
Preferred stock, \$.01 par value; 4,000,000 shares authorized, no shares issued or outstanding	-	-
Common stock, \$5.00 par value; 16,000,000 shares authorized, 1,946,496 shares issued in 2012 and 2011	9,732	9,732
Additional paid-in-capital	9,974	8,834
Retained earnings	129,502	120,675
Treasury stock, at cost (40,993 shares at December 31, 2012 and 59,242 at December 31, 2011)	(4,046)	(4,912)
Accumulated other comprehensive income, net	(2,937)	(1,455)
Total Canandaigua National Corporation Stockholders' Equity	142,225	132,874
Non-controlling interests	2,138	2,364
Total Equity	144,363	135,238
Total Liabilities and Equity	\$ 1,887,028	1,760,764

See accompanying notes to consolidated financial statements.

CANANDAIGUA NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 2012, 2011 and 2010

(dollars in thousands, except per share data)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Interest income:			
Loans, including fees	\$ 66,963	64,907	67,571
Securities	7,014	7,936	8,652
Federal funds sold	132	354	207
Other	13	24	36
Total interest income	<u>74,122</u>	<u>73,221</u>	<u>76,466</u>
Interest expense:			
Deposits	5,654	8,843	12,113
Borrowings	92	-	207
Junior subordinated debentures	2,773	2,905	3,005
Total interest expense	<u>8,519</u>	<u>11,748</u>	<u>15,325</u>
Net interest income	<u>65,603</u>	<u>61,473</u>	<u>61,141</u>
Provision for loan losses	4,300	3,775	6,150
Net interest income after provision for loan losses	<u>61,303</u>	<u>57,698</u>	<u>54,991</u>
Non-interest income:			
Service charges on deposit accounts	11,713	10,972	10,725
Trust and investment services income	12,916	12,445	10,984
Brokerage and investment subadvisory services income	2,819	280	86
Net gain on sale of mortgage loans	3,959	2,126	2,366
Loan servicing income, net	876	928	877
Loan-related fees	431	267	351
Loss on securities transactions, net	(118)	(191)	(170)
Other non-interest income	2,527	1,981	1,502
Total non-interest income	<u>35,123</u>	<u>28,808</u>	<u>26,721</u>
Operating expenses:			
Salaries and employee benefits	38,407	35,019	30,526
Occupancy, net	8,142	7,530	6,805
Technology and data processing	5,309	4,480	3,881
Professional and other services	3,812	4,751	3,297
Marketing and public relations	3,077	2,829	2,515
Office supplies, printing and postage	1,665	1,556	1,470
Intangible amortization	1,504	1,187	995
Other real estate operations	854	1,049	1,297
FDIC insurance	1,186	1,405	2,152
Other operating expenses	5,419	4,597	4,913
Total operating expenses	<u>69,375</u>	<u>64,403</u>	<u>57,851</u>
Income before income taxes	27,051	22,103	23,861
Income taxes	8,434	6,178	6,205
Net income attributable to noncontrolling interests and Canandaigua National Corporation	18,617	15,925	17,656
Less: Net loss attributable to noncontrolling interests	(220)	(387)	-
Net income attributable to Canandaigua National Corporation	<u>\$ 18,837</u>	<u>16,312</u>	<u>17,656</u>
Basic earnings per share	<u>\$ 9.98</u>	<u>8.64</u>	<u>9.35</u>
Diluted earnings per share	<u>\$ 9.76</u>	<u>8.48</u>	<u>9.20</u>

See accompanying notes to consolidated financial statements.

CANANDAIGUA NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
[WITH RESPECTIVE TAX INFORMATION PRESENTED PARENTHETICALLY]

Years Ended December 31, 2012, 2011 and 2010
(dollars in thousands)

		<u>2012</u>	<u>2011</u>	<u>2010</u>
Net income	\$	18,617	15,925	17,656
Other comprehensive income:				
Change in fair value of interest rate swaps, net of taxes of (\$760), (\$1,341) and \$180 respectively		(987)	(2,141)	324
Change in unrealized gain on on securities available for sale, net of taxes of (\$329), \$180 and (\$483) respectively		(468)	346	(971)
Plus reclassification adjustment for realized gains and losses included in net income on called securities, net of taxes of (\$9), \$69 and \$44 respectively		(27)	141	86
Other comprehensive income	\$	<u>(1,482)</u>	<u>(1,654)</u>	<u>(561)</u>
Total comprehensive income		<u>17,135</u>	<u>14,271</u>	<u>17,095</u>
Comprehensive income attributable to the noncontrolling interest	\$	<u>(220)</u>	<u>(387)</u>	<u>-</u>
Comprehensive income attributable to the Company	\$	<u>17,355</u>	<u>14,658</u>	<u>17,095</u>

See accompanying notes to consolidated financial statements.

CANANDAIGUA NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years Ended December 31, 2012, 2011 and 2010

(dollars in thousands, except share data)

	Number of Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Non- controlling Interest	Total
Balance at December 31, 2009	1,883,344	\$ 9,732	8,591	97,795	(5,143)	760	-	111,735
Comprehensive income:								
Change in fair value of interest rate swaps, net of taxes of \$180		-	-	-	-	324	-	324
Change in unrealized gain on securities available for sale, net of taxes of (\$483)		-	-	-	-	(971)	-	(971)
Plus reclassification adjustment for realized losses included in net income on called securities, net of taxes of \$44		-	-	-	-	86	-	86
Net income		-	-	17,656	-	-	-	17,656
Total comprehensive income								
Purchase of treasury stock	(5,564)	-	-	-	(511)	-	-	(511)
Shares issued as compensation	624	-	-	-	54	-	-	54
Exercise of stock options, including tax benefit of \$232	10,344	-	232	(562)	872	-	-	542
Cash dividend - \$ 2.72 per share		-	-	(5,121)	-	-	-	(5,121)
Balance at December 31, 2010	<u>1,888,748</u>	<u>\$ 9,732</u>	<u>8,823</u>	<u>109,768</u>	<u>(4,728)</u>	<u>199</u>	<u>-</u>	<u>123,794</u>
Comprehensive income:								
Change in fair value of interest rate swaps, net of taxes of (\$1,341)		-	-	-	-	(2,141)	-	(2,141)
Change in unrealized gain on securities available for sale, net of taxes of \$180		-	-	-	-	346	-	346
Plus reclassification adjustment for realized gains and losses included in net income on called securities, net of taxes of \$69		-	-	-	-	141	-	141
Net income attributable to non-controlling interest and Canandaigua National Corporation		-	-	16,312	-	-	(387)	15,925
Total comprehensive income				16,312	-	(1,654)	(387)	14,271
Purchase of treasury stock	(1,912)	-	-	-	(219)	-	-	(219)
Shares issued as compensation	418	-	11	-	35	-	-	46
Cash dividend - \$ 2.87 per share		-	-	(5,405)	-	-	-	(5,405)
Change in non-controlling interest		-	-	-	-	-	2,757	2,757
Dividend to non-controlling interests		-	-	-	-	-	(6)	(6)
Balance at December 31, 2011	<u>1,887,254</u>	<u>\$ 9,732</u>	<u>8,834</u>	<u>120,675</u>	<u>(4,912)</u>	<u>(1,455)</u>	<u>2,364</u>	<u>135,238</u>
Comprehensive income:								
Change in fair value of interest rate swaps, net of taxes of (\$760)		-	-	-	-	(987)	-	(987)
Change in unrealized gain on securities available for sale, net of taxes of (\$329)		-	-	-	-	(468)	-	(468)
Plus reclassification adjustment for realized gains and losses included in net income on called securities, net of taxes of (\$9)		-	-	-	-	(27)	-	(27)
Net income (loss) attributable to non-controlling interest and Canandaigua National Corporation		-	-	18,837	-	-	(220)	18,617
Total comprehensive income				18,837	-	(1,482)	(220)	17,135
Purchase of treasury stock	(9,715)	-	-	-	(1,442)	-	-	(1,442)
Shares issued as compensation	264	-	18	-	21	-	-	39
Exercise of stock options (\$1,122 tax benefit)	27,700	-	1,122	(1,035)	2,287	-	-	2,374
Cash dividend - \$ 4.74 per share		-	-	(8,975)	-	-	-	(8,975)
Dividend to non-controlling interests		-	-	-	-	-	(6)	(6)
Balance at December 31, 2012	<u>1,905,503</u>	<u>\$ 9,732</u>	<u>9,974</u>	<u>129,502</u>	<u>(4,046)</u>	<u>(2,937)</u>	<u>2,138</u>	<u>144,363</u>

See accompanying notes to consolidated financial statements.

CANANDAIGUA NATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2012, 2011 and 2010
(dollars in thousands)

	2012	2011	2010
Cash flow from operating activities:			
Net income attributable to Canandaigua National Corporation	\$ 18,837	16,312	17,656
Adjustments to reconcile net income to			
Net cash provided by operating activities:			
Depreciation, amortization and accretion	7,216	6,097	5,285
Provision for loan losses	4,300	3,775	6,150
Gain on sale of premises and equipment and other real estate, net	(213)	(105)	(32)
Writedown of other real estate	200	208	493
Deferred income tax benefit	(1,328)	(574)	(763)
Income from equity-method investments, net	(336)	(363)	59
Loss on calls of securities and write-down, net	118	191	170
Gain on sale of mortgage loans, net	(3,959)	(2,126)	(2,366)
Originations of loans held for sale	(271,815)	(166,240)	(203,582)
Proceeds from sale of loans held for sale	262,217	174,923	198,492
Increase in other assets	(689)	304	3,564
Increase in all other liabilities	1,679	2,930	(2,857)
Net cash provided by operating activities	16,227	35,332	22,269
Cash flow from investing activities:			
Securities available-for-sale:			
Proceeds from maturities and calls	103,842	80,156	65,844
Purchases	(93,322)	(79,888)	(62,409)
Securities held to maturity:			
Proceeds from maturities and calls	36,329	42,613	33,256
Purchases	(46,632)	(55,228)	(31,076)
Loan originations in excess of principal collections, net	(158,306)	(99,398)	(45,135)
Purchase of premises and equipment, net	(1,597)	(4,044)	(4,428)
Calls of FHLB stock, net of purchases of FHLB and FRB stock	(95)	(196)	229
Other investments - net	(679)	(5)	(752)
Acquisition of WBI net of cash acquired	-	(1,725)	-
Proceeds from sale of other real estate	3,261	1,158	1,144
Net cash used by investing activities	(157,199)	(116,557)	(43,327)
Cash flow from financing activities:			
Net increase in demand, savings and money market deposits	144,104	163,466	96,846
Net decrease in time deposits	(27,851)	(90,186)	(1,213)
Principal repayments of term borrowings	(2,632)	(330)	(9,534)
Proceeds from sale of treasury stock	39	46	54
Payments to acquire treasury stock	(1,442)	(219)	(511)
Proceeds from issuance of treasury stock under stock option plan	1,252	-	310
Tax benefit from stock option exercise	1,122	-	232
Change in noncontrolling interest, net	(226)	2,364	-
Dividends paid	(8,975)	(5,405)	(5,121)
Net cash provided by financing activities	105,391	69,736	81,063
Net (decrease) increase in cash and cash equivalents	(35,581)	(11,489)	60,005
Cash and cash equivalents - beginning of period	126,740	138,229	78,224
Cash and cash equivalents - end of period	\$ 91,159	126,740	138,229
Supplemental disclosure of cash flow information:			
Interest paid	\$ 8,575	12,251	15,444
Income taxes paid	8,336	7,395	8,029
Supplemental schedule of noncash investing activities			
Real estate acquired in settlement of loans	\$ 2,534	1,861	2,927
Acquisitions:			
Fair value of assets acquired (noncash)	-	8,878	-
Fair value of liabilities assumed	-	8,454	-

See accompanying notes to consolidated financial statements.

(1) Summary of Significant Accounting Policies

Business

Canandaigua National Corporation (the Company) provides a full range of financial services, including banking, trust, investment, brokerage, and insurance services to individuals, corporations, and municipalities. The Company is subject to competition from other financial services and commercial companies in various regulated and unregulated industries. The Company and its subsidiaries are subject to the regulations of certain federal and state agencies and undergo regular examinations by those regulatory authorities.

Basis of Presentation

The Consolidated Financial Statements include the accounts of the Company and its wholly- and majority-owned subsidiaries. Its principal operations comprise the activities of The Canandaigua National Bank and Trust Company (the Bank), CNB Mortgage Company (CNBM), Genesee Valley Trust Company (GVT), and WBI OBS Financial, LLC (OBS). OBS is included effective November 30, 2011, the date of its acquisition. Although the Company owns 65% of OBS, pursuant to U.S. Generally Accepted Accounting Principles, the Company is required to consolidate 100% of OBS within the financial statements. The 35% of OBS, which the Company does not own is separately accounted for as Non-controlling interests within the consolidated financial statements. All significant intercompany accounts and transactions have been eliminated in consolidation. The Company accounts for investments in less-than-majority-owned entities under the equity method. The Consolidated Financial Statements have been prepared in conformity with U.S. Generally Accepted Accounting Principles and conform to predominant practices within the financial services industry.

In preparing the Consolidated Financial Statements, management made estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements; as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates, particularly with respect to the allowance for loan losses and securities with other than temporary impairment.

Amounts in prior years' Consolidated Financial Statements are reclassified whenever necessary to conform to the current year's presentation.

Management has evaluated the impact of subsequent events on these financial statements to the date of filing of this Annual Report with the Securities and Exchange Commission.

Effective August 31, 2010, CNB Mortgage Company became a wholly-owned subsidiary of The Canandaigua National Bank and Trust Company. It was formerly a wholly-owned subsidiary of Canandaigua National Corporation. The reason for the change was to bring CNB Mortgage Company under the federal banking regulatory structure from New York State's banking regulatory structure, which had become increasingly rigid and costly. There was no change in the consolidated financial results, in segment reporting, or in management of the companies.

Cash Equivalents

For the purpose of reporting cash flows, cash and cash equivalents include cash, interest-bearing and other balances due from banks, and federal funds sold.

Securities

The Company classifies its debt securities as either available for sale or held to maturity as the Company does not hold any securities considered to be trading. Held to maturity securities are those that the Company has the ability and intent to hold until maturity. Held to maturity securities are recorded at amortized cost. All other securities not included as held to maturity are classified as available for sale.

Available for sale securities are recorded at fair value. Except for unrealized losses charged to earnings for other-than-temporary-impairment deemed to be credit-related or based on intent to sell, unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and are included in accumulated other comprehensive income (loss) in stockholders' equity until realized.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which the fair value has been less than cost; (2) the financial condition and near-term prospects of the issuer; and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. A decline in fair value of any security below cost that is deemed other than temporary ("OTTI") and related to the credit-worthiness of the issuer is charged to earnings, resulting in the establishment of a new cost basis for the security. Management generally evaluates the credit-worthiness of the issuer based on their ability to produce sufficient cash flows to service the contractual debt obligation.

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Interest income and dividends are recognized when earned. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the interest method. Realized gains and losses are included in earnings and are determined using the specific identification method.

Loans

Loans, other than loans designated as held for sale, are stated at the principal amount outstanding net of deferred origination costs. Interest and deferred fees and costs on loans are credited to income based on the effective interest method. Loans held for sale are carried at the lower of cost or fair value.

The accrual of interest on commercial and real estate loans is generally discontinued, and previously accrued interest is reversed, when the loans become 90 days delinquent or when, in management's judgment, the collection of principal and interest is uncertain. Loans are returned to accrual status when the doubt no longer exists about the loan's collectability and the borrower has demonstrated a sustained period of timely payment history. Specifically, the borrower will have resumed paying the full amount of scheduled interest and principal payments; all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period (6 months); and there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms involving payments of cash or cash equivalents. Interest on consumer loans is accrued until the loan becomes 120 days past due at which time principal and interest are generally charged off.

Management, considering current information and events regarding the borrowers' ability to repay their obligations, considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is considered to be impaired, and sufficient information exists to make a reasonable estimate of the inherent loss, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the loan's observable fair value or the fair value of underlying collateral if the loan is collateral-dependent. In the absence of sufficient, current data to make a detailed assessment of collateral values or cash flows, management measures impairment on a pool basis using historical loss factors equivalent to similarly impaired loans. Impairment reserves are included in the allowance for loan losses through a charge to the provision for loan losses. Cash receipts on impaired loans are generally applied to reduce the principal balance outstanding. In considering loans for evaluation of specific impairment, management generally excludes smaller balance, homogeneous loans: residential mortgage loans, home equity loans, and all consumer loans, unless such loans were restructured in a "troubled debt restructuring." These loans are collectively evaluated for risk of loss on a pool basis.

Allowance for Loan Losses

The allowance for loan losses is a valuation reserve for probable and inherent incurred losses in the loan portfolio. Credit losses arise primarily from the loan portfolio, but may also be derived from other credit-related sources, when drawn upon, such as commitments, guarantees, and standby letters of credit. Additions are made to the allowance through periodic provisions, which are charged to expense. All losses of principal are charged to the allowance when incurred or when a determination is made that a loss is expected. Subsequent recoveries, if any, are credited to the allowance.

The Company has established a process to assess the adequacy of the allowance for loan losses and to identify the risks in the loan portfolio. This process consists of the identification of specific reserves for impaired commercial loans and residential mortgages, and the calculation of general reserves, which is a formula-driven allocation.

The calculation of the general reserve involves several steps. A historical loss factor is applied to each loan by loan type and loan classification. The historical loss factors are calculated using a loan-by-loan, trailing eight-quarter net loss migration analysis for commercial loans. For all other loans, a portfolio-wide, trailing eight-quarter net loss migration analysis is used. Adjustments are then made to the historical loss factors based on current-period quantitative objective elements (delinquency, non-performing assets, classified/criticized loan trends, charge-offs, concentrations of credit, recoveries, etc.) and subjective elements (economic conditions, portfolio growth rate, portfolio management, credit policy, and others). This methodology is applied to the commercial, residential mortgage, and consumer portfolios, and their related off-balance sheet exposures. Any allowance for off-balance sheet exposures is recorded in Other Liabilities.

While management uses available information to recognize losses on loans, future additions to the allowance may be necessary. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Troubled Debt Restructurings

In the process of resolving nonperforming loans, we may choose to restructure the contractual terms of certain loans and attempt to work out alternative payment schedules with the borrower in order to avoid foreclosure of collateral. Any loans that are modified are evaluated to determine if they are "troubled debt restructurings" (TDR) and if so, are evaluated for

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impairment. A TDR is defined as a loan restructure where for legal or economic reasons related to a borrower's financial difficulties, the creditor grants one or more concessions to the borrower that it would not otherwise consider. Terms of loan agreements may be modified to fit the ability of the borrower to repay in respect of its current financial status and restructuring of loans may include the transfer of assets from the borrower to satisfy debt, a modification of loan terms, or a combination of the two. If a satisfactory restructure and payment arrangement cannot be reached, the loan may be referred to legal counsel for foreclosure.

Premises and Equipment

Land is carried at cost. Land improvements, buildings, leasehold improvements and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation is computed using straight-line and accelerated methods over the estimated useful lives of the assets, three to twenty-five years. Amortization of leasehold improvements is provided over the lesser of the term of the lease, including renewal options, when applicable, or the estimated useful lives of the assets.

Other Real Estate

Real estate acquired through foreclosure or deed in lieu of foreclosure (other real estate) is included in other assets and is recorded at the lower of the unpaid loan balance on the property at the date of transfer, or fair value, less estimated costs to sell. Adjustments made to the value at transfer are charged to the allowance for loan losses. After transfer, the property is carried at the lower of cost or fair value less estimated costs to sell. Adjustments to the carrying values of such properties that result from subsequent declines in value are charged to operations in the period in which the declines occur. Operating earnings and costs associated with the properties are charged to other non-interest income and operating expense as incurred. Gains on the sale of other real estate are included in results of operations when the sale occurs.

Loan Servicing Assets

The Company services first-lien, residential loans for the Federal Home Loan Mortgage Company (FHLMC), also known as Freddie Mac, and certain commercial loans as lead participant. The associated servicing rights (assets) entitle the Company to a future stream of cash flows based on the outstanding principal balance of the loans and contractual servicing fees. Failure to service the loans in accordance with contractual requirements may lead to a termination of the servicing rights and the loss of future servicing fees.

The Company services all loans for FHLMC on a non-recourse basis; therefore, its credit risk is limited to temporary advances of funds to FHLMC, while FHLMC retains all credit risk associated with the loans. Commercial loans are serviced on a non-recourse basis, whereby the Company is subject to credit losses only to the extent of the proportionate share of the loan's principal balance owned. The Company's contract to sell loans to FHLMC and to the Federal Housing Administration (FHA) via third-parties contain certain representations and warranties that if not met by the Company would require the repurchase of such loans. The Company has not historically been subject to a material volume of repurchases nor is it as of the current year end.

Loan servicing assets are amortized to loan servicing income in the statement of income. In computing amortization expense, the Company uses historical prepayment rates for similar loan pools and applies this amortization rate to each pool. If prepayments occur at a rate different than the applied rate, the Company adjusts the specific pool's amortization in the period in which the change occurs.

For purposes of evaluating and measuring impairment of loan servicing rights, the Company stratifies these assets based on predominant risk characteristics of the underlying loans that are expected to have the most impact on projected prepayments, cost of servicing, and other factors affecting future cash flows associated with the servicing rights, such as loan type, rate, and term. The amount of impairment recognized is the amount by which the carrying value of the loan servicing rights for a stratum exceeds fair value. Impairment is recognized through the income statement.

Goodwill and Intangible Assets

Goodwill has an indefinite useful life and is not amortized, but is tested for impairment. Goodwill impairment tests are performed on an annual basis or when events or circumstances dictate. A qualitative assessment of goodwill is first performed, factoring company-specific and economic characteristics that might impact its carrying value. If the assessment indicates goodwill might be impaired, a quantitative test is performed in which the fair value of the reporting unit with goodwill is compared to the carrying amount of that reporting unit in order to determine if impairment is indicated. If so, the implied fair value of the reporting unit's goodwill is compared to its carrying amount and an impairment loss is measured by the excess of the carrying value over fair value. Fair value of goodwill is estimated using a weighted average of market-based analysis and discounted cash-flow income analysis of the underlying reporting unit.

Intangible assets that have finite useful lives, such as customer relationship, technology, and trade name intangibles, are amortized over their useful lives. Customer relationship intangibles are generally amortized over 15 years using an accelerated method. Technology is generally amortized over a five year period also using an accelerated method. Trade name intangible

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has been amortized on a straight-line basis over three years. Amortization of these assets is reported in other operating expenses. The amortization period is monitored to determine if circumstances require the period to be revised. The Company also periodically reviews its intangible assets for changes in circumstances that may indicate that the carrying amount of the assets are impaired. The Company tests its intangible assets for impairment if conditions indicate that an impairment loss has more likely than not been incurred by evaluating the recoverability of the assets' carrying value using estimates of undiscounted future cash flows over the remaining assets' lives. Any impairment loss is measured by the excess of carrying value over fair value and is recorded in the measured period as additional amortization expense.

Stock-Based Compensation

Stock-based compensation expense is recognized in the statement of income over the awards' vesting period based on the fair value of the award at the grant date.

The Company accounts for the liability associated with its stock appreciation rights plan at fair value which is re-measured each quarterly reporting period. Fair value is measured using the Black-Scholes-Merton option pricing model. The associated compensation expense or credit reported in the statement of income represents the change in the re-measured liability.

Income Taxes

The Company and its wholly-owned subsidiaries file income tax returns in the U.S. Federal jurisdiction and principally in the states of New York and Florida. Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

The Company recognizes interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

Derivative Financial Instruments

Derivatives are recognized as either assets or liabilities in the balance sheet and are measured at fair value. If certain conditions are met, a derivative may be specifically designated as: (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (b) a hedge of the exposure to variable cash flows of a forecasted transaction; or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available for sale security, or a foreign currency denominated forecasted transaction. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation. At inception of the hedge, management establishes the application of hedge accounting and the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. These are consistent with management's approach to managing risk.

The Company's derivative financial instruments include: (1) commitments to originate fixed-rate residential real estate loans to be held for sale; (2) commitments to sell fixed-rate residential loans; and (3) interest rate swap agreements.

Commitments to originate and commitments to sell fixed-rate residential real estate loans are recorded in the consolidated balance sheet at estimated fair value. Neither of these derivatives instruments is considered a hedge; therefore, periodic changes in the fair value of these instruments are recognized in mortgage banking income in the period in which the change occurs. However, due to the minimal volume and short-term nature of these instruments, the net impact of a change in fair value from the instruments' initially recognized fair value is generally immaterial.

The Company utilizes interest rate swap agreements as part of its management of interest rate risk to modify the repricing characteristics of its floating-rate junior subordinated debentures. For swap agreements, amounts receivable or payable are recognized as accrued under the terms of the agreement, and the net differential is recorded as an adjustment to interest expense of the related debentures. Interest rate swap agreements are designated as cash flow hedges. Therefore, the effective portion of the swaps' unrealized gain or loss was initially recorded as a component of other comprehensive income, and subsequent effective portions are recognized in interest expense. The ineffective portion of the unrealized gain or loss, if any, is reported in other operating income.

Common and Preferred Stock and Stock Split

At a special meeting of the Company's shareholders held on September 14, 2011, the Company's shareholders approved (a) a 4-for-1 forward stock split of the Company's common stock (the "Stock Split") and (b) a corresponding amendment to the Company's Certificate of Incorporation that would affect the stock split by increasing the Company's total number of authorized shares from 8,000,000 to 20,000,000 shares, increasing the authorized number of shares of common stock from 4,000,000 to

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16,000,000 shares, including changing the par value per share from \$20.00 to \$5.00, and implementing the Stock Split. The amendment to the Company's Certificate of Incorporation effecting the Stock Split was filed with New York State on September 20, 2011. All share data has been adjusted retroactively to reflect this stock split.

At the Company's April 2011 Annual Meeting, shareholders authorized a class of 4,000,000 shares of preferred stock, \$.01 par value. No shares of preferred stock have been issued.

Accumulated Other Comprehensive Income (Loss)

The Company's comprehensive income consists of net income, changes in the net unrealized holding gains and losses of securities available for sale, and the unrealized gain or loss on the effective portion of cash flow hedges. Accumulated other comprehensive income (loss) on the consolidated statements of stockholders' equity is presented net of taxes.

Treasury Stock

Treasury stock is carried on the consolidated balance sheet at cost as a reduction of stockholders' equity. Shares are released from treasury at original cost on a first-in, first-out basis, with any gain on the sale reflected as an adjustment to additional paid-in capital. Losses are reflected as an adjustment to additional paid-in capital to the extent of gains previously recognized, otherwise as an adjustment to retained earnings.

Trust and Investment Services Income

Assets held in fiduciary or agency capacity for clients are not included in the accompanying consolidated balance sheets, since such assets are not assets of the Company. Fees are calculated based generally upon the market value of the underlying assets. Fee income is recognized when earned, and is not subject to return-performance contingencies.

Earnings Per Share

Basic earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of shares outstanding during the year. Diluted earnings per share includes the maximum dilutive effect of stock issuable upon exercise of stock options.

New Accounting Standards

The following Accounting Standards Updates (ASU) were implemented as of January 1, 2012 with no material impact to the financial condition or results of operations. However, a new statement was added and some footnotes were revised:

ASU 2011-03. *Reconsideration of Effective Control for Repurchase Agreements*, issued April 2011. The main objective in developing this Update was to improve the accounting for repurchase agreements (repos) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments in this Update removed from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control were not changed by the amendments in this Update.

ASU 2011-04 *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, issued May 2011. The amendments were intended to converge fair value measurement and disclosure guidance in U.S. GAAP with the guidance in the International Accounting Standards Board's concurrently issued IFRS 13, *Fair Value Measurement*. The amendments in ASU 2011-04 did not modify the requirements for when fair value measurements apply; rather, they generally represented clarifications on how to measure and disclose fair value under ASC 820, *Fair Value Measurement*.

ASU 2011-05 *Presentation of Comprehensive Income*, issued June 2011. The objective of this Update was to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The amendments required that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements.

In ASU 2011-12 *Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, the FASB indefinitely deferred certain reporting requirements for reclassifications out of accumulated other comprehensive income on a components basis.

ASU 2011-08 *Testing Goodwill for Impairment*, issued September 2011. The objective of this Update was to simplify how entities, both public and non-public, test goodwill for impairment. The amendments in the Update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. The

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more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Previous guidance required an entity to test goodwill for impairment, on at least an annual basis, by comparing the fair value of a reporting unit with its carrying amount, including goodwill (step one). If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the amendments in this Update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount.

The following Accounting Standards Updates (ASU) were implemented in 2011 with no material impact to the Company's financial condition or results of operations:

ASU 2010-28, *Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)*. ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors. The qualitative factors are consistent with the existing guidance and examples in paragraph 350-20-35-30, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

ASU 2010-29, *Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)*. ASU 2010-29 specifies that if a public entity presents comparative financial statements, the entity (acquirer) should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. It also expands the supplemental pro forma disclosures under Topic 805 to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings.

ASU 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, issued April, 2011. The amendments in this Update clarify the guidance on a creditor's evaluation of whether it has granted a concession. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (1) the restructuring constitutes a concession; and (2) the debtor is experiencing financial difficulties. The amendments in this Update were effective beginning with the third quarter of 2011, and were to be applied retrospectively to the beginning of 2011. In general, the Company does not renegotiate nor does it materially modify loans to troubled borrowers. Loans to troubled borrowers are typically placed in non-accrual status in advance of any consideration of renegotiation, and in only rare instances will the Company renegotiate a loan that results in a material concession to the borrower.

In addition to the Updates enumerated above, the Financial Accounting Standards Board issues, from time to time, updates containing technical amendments. These updates are generally effective immediately upon their issuance, but have no practical impact on our financial condition or results of operations. Because these are technical in nature, and have no material impact, a summary is not included herein.

(2) Acquisitions of Trust and Investment Companies and Trust and Investment Management Accounts

On November 30, 2011, the Company acquired a majority interest in WBI OBS Financial, LLC (WBI), a company formed to concurrently acquire OBS Holdings, Inc. (OBS). OBS, an Ohio-based company, provides brokerage and investment sub-advisory services to the Bank and several other financial institutions, primarily community banks and credit unions, and had approximately \$900 million in managed assets. Under the terms of WBI's acquisition, it will pay the seller a total of \$7 million, consisting of a \$2.5 million payment in May 2012, a \$3.5 million payment in November 2013, and \$1 million cumulative quarterly non-maturity payments contingent upon net revenue improvements at OBS, all of which was included in Borrowings at December 31, 2011. Under the terms of the Company's purchase of WBI, in exchange for a 65% ownership interest, the Company paid WBI \$2.3 million on November 30, 2011, and is to pay an additional \$0.2 million. Additionally, the company funded the \$2.5 million payment due May 31, 2012 for a total of \$5.0 million. Future obligations of WBI will be shared pro-rata with other WBI investors. WBI investors have agreed to allocate up to 15% of the ownership structure to employees of OBS, subject to certain conditions. The results of WBI's consolidated operations are included in the Consolidated Statements of Income from the date of acquisition. In 2011, WBI reported an approximate \$1.1 million loss, which was a result of merger-related legal and advisory expenses.

The acquisition resulted in the recording of certain intangible assets (customer list: \$2.3 million and technology: \$0.9 million), related deferred tax liabilities of \$1.3 million, and goodwill of \$6.8 million. In addition, a non-interest bearing note payable totaling \$7.0 million was recorded along with a discount on the note of \$0.2 million. The fair value of the non-controlling interest was estimated at \$2.7 million. The customer list intangible is being amortized on an accelerated basis over twelve years and technology over five years. The note discount is being amortized over three years to interest expense.

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The allocation of the purchase price was based on the fair value of assets acquired and liabilities assumed as of the acquisition date. During 2012, the Company completed its comprehensive analysis of the fair value of assets acquired and liabilities assumed. In addition to changes in those assets and liabilities, the revisions resulted in a reduction in goodwill of approximately \$0.2 million. The December 31, 2011 consolidated balance sheet has been adjusted to reflect the results of this analysis.

The following table presents a summary of the fair value of assets acquired and liabilities assumed (in thousands):

Consideration paid:

Cash to be paid to WBI	\$	5,000
Fair value of non-controlling interest		2,700
Total consideration	\$	<u>7,700</u>

Estimated recognized amounts of identifiable assets acquired:

Cash and equivalents	\$	525
Premises and equipment		61
Other assets		5,617
Customer list intangible		2,300
Technology		900
Due to seller, net of discount		(6,836)
Accrued expenses		(338)
Deferred tax liability		<u>(1,280)</u>
Total identifiable net assets		949

Goodwill: \$ 6,751

On September 29, 2006, the Bank acquired investment management accounts from another bank and assumed the successor trustee role for personal trusts. The market value of the underlying assets was approximately \$66.6 million and was added to existing assets under administration. In connection with the acquisition, the Company recorded, at cost, a customer list intangible asset of approximately \$1.4 million. The asset is being amortized on an accelerated basis over fifteen years. As a result of the Company's annual fair value estimation in 2011, an additional \$50,000 amortization expense over expected amortization was recorded to reflect customer account attrition in excess of original estimates.

On January 2, 2008, the Company completed its acquisition of 100% of the voting shares of Genesee Valley Trust Company (GVT), a Rochester-based New York State chartered trust company. The acquisition of GVT provided the Company with additional trust and investment services income. The total cash purchase price approximated \$18.8 million. A payment of \$13.1 million was made at closing, and subsequent payments of \$4.1 million, \$1.3 million, and \$0.3 million were made each January 2009, 2010, and 2011, respectively. The acquisition resulted in the recording of certain intangible assets (customer list: \$6.9 million; trade name: \$0.1 million) and goodwill, all of which totaled \$8.8 million and substantially all of which was deductible for income tax purposes. In addition, a non-interest bearing note payable totaling \$5.5 million was recorded along with a discount on the note of \$0.5 million. The customer list intangible is being amortized on an accelerated basis over fifteen years, the trade name was amortized over three years. The note discount was amortized over three years to interest expense. As a result of the Company's annual fair value estimation in 2011, an additional \$250,000 amortization expense over expected amortization was recorded to reflect customer account attrition in excess of original estimates.

On December 31, 2008, the Bank acquired from an investment management company, investment management accounts. The market value of the underlying assets was approximately \$42.6 million and was added to existing assets under administration. An initial payment of \$0.3 million was made at closing with subsequent payments of \$0.2 million in December 2009 and \$0.2 million in December 2010. The acquisition resulted in the recording of a customer list intangible asset of \$0.7 million, substantially all of which was deductible for income tax purposes. The Company also recorded a non-interest bearing note totaling \$0.3 million, which was paid as of December 31, 2010. The intangible asset is being amortized on an accelerated basis over fifteen years.

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Acquisition-related identifiable intangible assets were comprised of the following at December 31, (in thousands):

	<u>2012</u>	<u>2011</u>
Gross carrying amounts		
Customer list intangible from 2006	\$ 1,420	1,420
Customer list intangible from GVT	6,870	6,870
Trade name from GVT	100	100
Customer list intangible from investment company	665	665
Customer list intangible from OBS	2,300	2,300
Technology intangible from OBS	900	900
Total	<u>12,255</u>	<u>12,255</u>
Less accumulated amortization	<u>(6,022)</u>	<u>(4,518)</u>
Intangible asset – net	<u>\$ 6,233</u>	<u>7,737</u>

Amortization expense amounted to \$1,504,000, \$1,187,000, and \$995,000 for the years ended December 31, 2012, 2011, and 2010, respectively. Amortization expense is projected over the next five years as follows: 2013: \$1,241,000, 2014: \$1,095,000; 2015: \$991,000; 2016: \$875,000 and 2017: \$643,000.

(3) Securities

Amortized cost and fair value of available-for-sale and held-to-maturity securities at 2012 are summarized as follows:

	<u>December 31, 2012</u>			<u>Fair Value</u>
	<u>Amortized Cost ⁽¹⁾</u>	<u>Gross Unrealized</u>		
		<u>Gains</u>	<u>Losses</u>	
<u>Securities Available for Sale:</u>				
U.S. Treasury	\$ 500	-	-	500
U.S. government sponsored enterprise obligations	60,158	214	(196)	60,176
State and municipal obligations	37,512	1,196	(22)	38,686
Corporate obligations ⁽¹⁾	1,073	23	(185)	911
Equity securities	2,293	208	-	2,501
		<u>1,641</u>	<u>(403)</u>	
Total Securities Available for Sale	<u>\$ 101,536</u>	<u>1,641</u>	<u>(403)</u>	<u>102,774</u>

⁽¹⁾Amortized cost includes cumulative \$360,000 write-down prior to 2010 for other-than-temporary impairment.

Securities Held to Maturity:

U.S. government sponsored enterprise obligations	\$ 5	-	-	5
State and municipal obligations	175,065	3,858	(112)	178,811
Corporate obligations	780	419	-	1,199
		<u>4,277</u>	<u>(112)</u>	
Total Securities Held to Maturity	<u>\$ 175,850</u>	<u>4,277</u>	<u>(112)</u>	<u>180,015</u>

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Amortized cost and fair value of available-for-sale and held-to-maturity securities at December 31, 2011 are summarized as follows:

	December 31, 2011			Fair Value
	Amortized Cost ⁽¹⁾	Gross Unrealized		
		Gains	Losses	
Securities Available for Sale:				
U.S. Treasury	\$ 502	-	-	502
U.S. government sponsored enterprise obligations	55,766	377	(18)	56,125
State and municipal obligations	53,531	1,917	(23)	55,425
Corporate obligations	1,093	2	(296)	799
Equity securities	1,295	112	-	1,407
Total securities Available for Sale	\$ 112,187	2,408	(337)	114,258

⁽¹⁾Amortized cost includes cumulative write-downs of \$360,000 prior to 2010 for other-than-temporary impairment.

Securities Held to Maturity:				
U.S. government sponsored enterprise obligations	\$ 1,007	1	-	1,008
State and municipal obligations	165,348	5,113	(135)	170,326
Corporate obligations	870	313	-	1,183
Total Securities Held to Maturity	\$ 167,225	5,427	(135)	172,517

The amortized cost and fair value of debt securities by years to maturity as of December 31, 2012, follow (in thousands). Maturities of amortizing securities are classified in accordance with their contractual repayment schedules. Expected maturities will differ from contractual maturities since issuers may have the right to call or prepay obligations without penalties.

Years	Available for Sale		Held to Maturity	
	Amortized Cost ⁽¹⁾	Fair Value	Amortized Cost	Fair Value
Under 1	\$ 14,817	14,976	31,638	32,076
1 to 5	29,102	30,187	133,956	137,204
5 to 10	51,537	51,361	9,476	9,536
10 and over	3,787	3,749	780	1,199
Total	\$ 99,243	100,273	175,850	180,015

⁽¹⁾Amortized cost includes a cumulative \$360,000 write-down prior to 2010 for other-than-temporary impairment.

At December 31, 2012, and 2011, securities at amortized cost of \$208.0 million and \$209.8 million, respectively, were pledged to secure municipal deposits and for other purposes required or permitted by law.

During 2011, the Company sold \$0.1 million of corporate obligations at a minor loss. There were no securities sales in 2012 or 2010.

Interest on securities segregated between taxable interest and tax-exempt interest for the years ended December 31, 2012, 2011, and 2010, follows (in thousands):

	2012	2011	2010
Taxable	\$ 1,327	1,505	1,547
Tax-exempt	5,687	6,431	7,105
Total	\$ 7,014	7,936	8,652

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

	<u>Less than 12 months</u>		<u>Over 12 months</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
Securities Available for Sale:						
U.S. government sponsored enterprise obligations	\$ 28,787	187	1,615	9	30,402	196
State and municipal obligations	801	8	992	14	1,793	22
Corporate obligations	-	-	873	185	873	185
Total temporarily impaired securities	\$ <u>29,588</u>	<u>195</u>	<u>3,480</u>	<u>208</u>	<u>33,068</u>	<u>403</u>
Securities Held to Maturity:						
State and municipal obligations	\$ <u>10,044</u>	<u>66</u>	<u>5,809</u>	<u>46</u>	<u>15,853</u>	<u>112</u>
Total temporarily impaired securities	\$ <u>10,044</u>	<u>66</u>	<u>5,809</u>	<u>46</u>	<u>15,853</u>	<u>112</u>

Substantially all of the unrealized losses on the Company's securities were caused by market interest rate changes from those in effect when the specific securities were purchased by the Company. The contractual terms of these securities do not permit the issuer to settle the securities at a price less than par value. Except for certain corporate obligations, all securities rated by an independent rating agency carry an investment grade rating. Because the Company does not intend to sell the securities and it believes it is not likely to be required to sell the securities before recovery of their amortized cost basis, which may be, and is likely to be, maturity, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2012, except as discussed below.

In the available-for-sale portfolio, the Company holds approximately \$0.9 million of bank trust-preferred securities with an adjusted cost basis of \$1.1 million. These securities are backed by debt obligations of banks, with approximately \$0.8 million of the securities backed by two of the largest U.S. banks and \$0.1 million backed by a pool of banks' debt in the form of a collateralized debt obligation (CDO). As a result of market upheaval, a lack of regular trading market in these securities, and bank failures, the fair value of these securities had fallen sharply in 2008 and continued to fall in the first half of 2009. The Company recognized cumulative OTTI amounting to \$0.9 million on one CDO over several years. Management sold a portion of this security in 2011 and intends to sell the remainder in whole or in part over time. If the financial condition of the underlying banks deteriorates, further write-downs could occur before a sale, which would be reflected in the statement of operations. The maximum potential write-down would be its current carrying value of less than \$0.1 million.

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

	<u>Less than 12 months</u>		<u>Over 12 months</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
Securities Available for Sale:						
U.S. government sponsored enterprise obligations	\$ 7,610	18	-	-	7,610	18
State and municipal obligations	355	3	996	20	1,351	23
Corporate obligations	-	-	759	296	759	296
Total temporarily impaired securities	\$ <u>7,965</u>	<u>21</u>	<u>1,755</u>	<u>316</u>	<u>9,720</u>	<u>337</u>
Securities Held to Maturity:						
State and municipal obligations	\$ <u>7,886</u>	<u>80</u>	<u>4,647</u>	<u>55</u>	<u>12,533</u>	<u>135</u>
Total temporarily impaired securities	\$ <u>7,886</u>	<u>80</u>	<u>4,647</u>	<u>55</u>	<u>12,533</u>	<u>135</u>

The aggregate cost of the Company's cost-method investments totaled \$4.5 million at December 31, 2012 and 2011, of which \$2.7 million at each year end were in Federal Home Loan Bank stock and Federal Reserve Bank stock, as required by law.

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(4) Loans and Allowance for Loan Losses

Loans

The Company's market area is generally Ontario County and Monroe County of New York State. Substantially all loans are made in this market area. Accordingly, the ultimate collectability of a substantial portion of the Company's loan portfolio is susceptible to changes in the economic conditions in this area. The Company's concentrations of credit risk are as disclosed in the following table of loan classifications. The concentrations of credit risk in related loan commitments and letters of credit parallel the loan classifications reflected. Other than general economic risks, management is not aware of any material concentrations of credit risk to any industry or individual borrower.

The major classifications of loans at December 31, 2012 and December 31, 2011, follow (in thousands), along with a description of their underwriting and risk characteristics:

	<u>2012</u>	<u>2011</u>
Commercial and industrial	\$ 213,467	198,744
Mortgages:		
Commercial	525,413	467,413
Residential - first lien	286,972	256,173
Residential - second lien	100,099	101,877
Consumer:		
Automobile - indirect	283,836	227,541
Other	18,323	25,583
Other, including loans held for sale	<u>21,113</u>	<u>7,556</u>
 Total loans	 1,449,223	 1,284,887
Plus - Net deferred loan costs	9,549	7,634
Less - Allowance for loan losses	<u>(17,317)</u>	<u>(16,095)</u>
 Loans - net	 <u>\$ 1,441,455</u>	 <u>1,276,426</u>

Commercial and Industrial Loans: These loans generally include term loans and lines of credit. Such loans are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and equipment purchases. As a general practice, a collateral lien is placed on equipment or other assets owned by the borrower. These loans carry a higher risk than commercial real estate loans by the nature of the underlying collateral, which can be business assets such as equipment and accounts receivable. To reduce the risk, management also attempts to secure secondary collateral, such as real estate, and obtain personal guarantees of the borrowers. To further reduce risk and enhance liquidity, these loans generally carry variable rates of interest, repricing in three- to five-year periods, and have a maturity of five years or less. Lines of credit generally have terms of one year or less and carry floating rates of interest (e.g., prime plus a margin).

Commercial Mortgages: Commercial real estate loans are made to finance the purchases of real property which generally consists of real estate with completed structures. These commercial real estate loans are secured by first liens on the real estate, which may include apartments, commercial structures housing businesses, healthcare facilities, and other non-owner occupied facilities. These loans are considered by the Company to be less risky than commercial and industrial loans, since they are secured by real estate and buildings. The loans typically have adjustable interest rates, repricing in three- to five-year periods, and require principal payments over a 10- to 25-year period. Many of these loans include call provisions within 10 to 15 years of their origination. The Company's underwriting analysis includes credit verification, independent appraisals, a review of the borrower's financial condition, and the underlying cash flows. These loans are typically originated in amounts of no more than 80% of the appraised value of the property serving as collateral.

Residential First-Lien Mortgages: We originate adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a mortgage. These loans are collateralized by owner- and non-owner-occupied properties located in the Company's market area. They are amortized over five to 30 years. Substantially all residential loans secured by first mortgage liens are originated by CNB Mortgage and sold to either the Bank or third-party investors. Generally, fixed-rate mortgage loans with a maturity or call date of ten years or less and a rate of 4% or more are retained in the Company's portfolio. For longer term, fixed-rate residential mortgages without escrow, the Company generally retains the servicing, but sells the right to receive principal and interest to Federal Home Loan Mortgage Company, also known as Freddie Mac. All loans not retained in the portfolio or sold to Freddie Mac are sold to unrelated third parties with servicing released. This practice allows the Company to manage interest rate risk, liquidity risk, and credit risk. From time to time, the Company may also purchase residential mortgage loans which are originated and serviced by third parties. In an effort to manage risk of loss and strengthen secondary market liquidity opportunities, management typically uses secondary market

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underwriting, appraisal, and servicing guidelines. Loans on one-to-four-family residential real estate are mostly originated in amounts of no more than 85% of appraised value or have private mortgage insurance. Mortgage title insurance and hazard insurance are normally required. Construction loans have a unique risk, because they are secured by an incomplete dwelling. This risk is reduced through periodic site inspections, including at each loan draw period.

Residential Second-Lien Mortgages: The Company originates home equity lines of credit and second mortgage loans (loans secured by a second (junior) lien position on one-to-four-family residential real estate). These loans carry a higher risk than first mortgage residential loans as they are in a second position relating to collateral. Risk is reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower's financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate.

Consumer Loans: The Company funds a variety of consumer loans, including direct and indirect automobile (loans processed by automobile dealers on behalf of the Bank) loans, recreational vehicle loans, boat loans, aircraft loans, home improvement loans, and personal loans (collateralized and uncollateralized). Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from one to ten years, based upon the nature of the collateral and the size of the loan. The majority of consumer loans are underwritten on a secured basis using the underlying collateral being financed or a customer's deposit account. A small amount of loans are unsecured, which carry a higher risk of loss.

Loans Held for Sale: These are the Residential First-Lien Mortgages, discussed above, which are sold to Freddie Mac and other third parties. These loans are carried at their lower of cost or fair value, calculated on a loan-by-loan basis.

Commercial loan participations amounted to \$109,365,000 and \$114,969,000 at December 31, 2012 and 2011, respectively. Residential mortgage loans serviced for Freddie Mac, amounted to \$528,316,000 and \$461,950,000 at December 31, 2012 and 2011, respectively. None of these loans are included in the Consolidated Financial Statements or the tables within this Note.

Certain executive officers, directors and their business interests are customers of the Company. Transactions with these parties are based on substantially the same terms as similar transactions with unrelated third parties and do not carry more than normal credit risk. Borrowings by these related parties amounted to \$8,386,000 and \$5,366,000 at December 31, 2012, and 2011, respectively. During 2012, new borrowings amounted to \$4,519,000 (including borrowings of executive officers and directors that were outstanding at the time of their election), and repayments and other reductions were \$1,499,000. Additionally, the Bank has issued a letter of credit totaling \$3,500,000 to the Company's majority-owned subsidiary in connection with its acquisition of OBS in 2011.

Allowance for Loan Losses

A summary of the changes in the allowance for loan losses follows (in thousands). Notwithstanding the estimated allocations set forth in any table, the entirety of the allowance is available to absorb losses in any portfolio.

	Years Ended December 31,		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
Balance at the beginning of year	\$ 16,095	15,635	14,232
Loans charged off	(4,203)	(4,563)	(5,998)
Recoveries of loans charged off	1,125	1,248	1,251
Provision charged to operations	<u>4,300</u>	<u>3,775</u>	<u>6,150</u>
Balance at end of year	<u>\$ 17,317</u>	<u>16,095</u>	<u>15,635</u>

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The following table presents an analysis of the allowance for loan losses by loan type, including a summary of the loan types individually and collectively evaluated for impairment as of December 31, 2012 and 2011 (in thousands). Loan balances included in the "Unallocated" column represent the balance of net deferred loan costs.

December 31, 2012		Commercial and industrial	Commercial mortgage	Residential mortgage - first position	Residential mortgage - second position	Consumer - indirect	Consumer - other	Loans held for sale	Unallocated	Total
Beginning Balance	\$	6,393	994	1,786	521	4,839	916	-	646	16,095
Charge-offs		(907)	(746)	(673)	(48)	(1,341)	(488)	-	-	(4,203)
Recoveries		168	3	18	47	544	345	-	-	1,125
Provision		(2,393)	1,586	1,511	(54)	2,688	167	-	795	4,300
Ending Balance	\$	<u>3,261</u>	<u>1,837</u>	<u>2,642</u>	<u>466</u>	<u>6,730</u>	<u>940</u>	<u>-</u>	<u>1,441</u>	<u>17,317</u>

of which:

Amount for loans individually evaluated for impairment	\$	<u>515</u>	<u>88</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>603</u>
Amount for loans collectively evaluated for impairment	\$	<u>2,746</u>	<u>1,749</u>	<u>2,642</u>	<u>466</u>	<u>6,730</u>	<u>940</u>	<u>-</u>	<u>1,441</u>	<u>16,714</u>
Balance of loans individually evaluated for impairment	\$	<u>2,429</u>	<u>10,116</u>	<u>-</u>	<u>50</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>12,595</u>
Balance of loans collectively evaluated for impairment	\$	<u>211,038</u>	<u>515,297</u>	<u>286,972</u>	<u>100,049</u>	<u>283,836</u>	<u>18,323</u>	<u>21,113</u>	<u>9,549</u>	<u>1,446,177</u>

December 31, 2011

December 31, 2011		Commercial and industrial	Commercial mortgage	Residential mortgage - first position	Residential mortgage - second position	Consumer - indirect	Consumer - other	Loans held for sale	Unallocated	Total
Beginning Balance	\$	6,364	1,371	1,304	563	4,196	1,155	-	682	15,635
Charge-offs		(2,082)	(263)	(324)	(31)	(1,345)	(518)	-	-	(4,563)
Recoveries		153	-	142	9	700	244	-	-	1,248
Provision		1,958	(114)	664	(20)	1,288	35	-	(36)	3,775
Ending Balance	\$	<u>6,393</u>	<u>994</u>	<u>1,786</u>	<u>521</u>	<u>4,839</u>	<u>916</u>	<u>-</u>	<u>646</u>	<u>16,095</u>

of which:

Amount for loans individually evaluated for impairment	\$	<u>895</u>	<u>243</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,138</u>
Amount for loans collectively evaluated for impairment	\$	<u>5,498</u>	<u>751</u>	<u>1,786</u>	<u>521</u>	<u>4,839</u>	<u>916</u>	<u>-</u>	<u>646</u>	<u>14,957</u>
Balance of loans individually evaluated for impairment	\$	<u>3,828</u>	<u>9,078</u>	<u>-</u>	<u>31</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>12,937</u>
Balance of loans collectively evaluated for impairment	\$	<u>194,916</u>	<u>458,335</u>	<u>256,173</u>	<u>101,846</u>	<u>227,541</u>	<u>25,583</u>	<u>7,556</u>	<u>7,634</u>	<u>1,279,584</u>

The balance in the allowance for loan losses decreased to 1.19% of the loan portfolio at December 31, 2012 from 1.25% of the loan portfolio at December 31, 2011. This decrease was principally due to the lower level of specific loan impairment reserves compared to 2011 combined with several key credit quality measurements: Internally classified loans (loans rated 6,7,8) decreased, the percentage of non-performing loans to total loans decreased, and net charge-offs to average loans decreased. These improvements offset higher reserve requirements due to year-over-year portfolio growth. The most significant allocation reduction as a result of these improvements was a reduction of approximately \$2.4 million for commercial and industrial loans. Offsetting some of these reduced levels were increases to the consumer and residential mortgage pools resulting from significant loan growth and higher base loss factors associated with increases in the volume of past due loans.

Finally, due to improving economic conditions in our market (increased auto sales, increased home sales, stable median home prices, and improving consumer confidence in the Rochester area from last year) an 11 basis point economic factor adjustment was applied to the majority of the portfolio pools, down from 14 basis points in 2011.

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In monitoring the credit quality of the portfolio, management applies a credit quality indicator to substantially all commercial loans. These quality indicators range from one through eight in increasing risk of loss. These ratings are used as inputs to the calculation of the allowance for loan losses. Loans rated 1 through 4 are generally allocated a lesser percentage allocation in the allowance for loan losses than loans rated from 5 through 8. Residential Mortgage Loans are generally rated 9, unless they are used to partially collateralize commercial loans, in which case they carry the rating of the respective commercial loan relationship, or if management wishes to recognize a well defined weakness or loss potential to more accurately reflect credit risk. Unrated loans are allocated a percentage of the allowance for loan losses on a pooled-basis.

Loans rated 1 include borrowers whose financial condition, liquidity, capitalization, earnings, cash flow, management and capacity to repay are strong. If deficient in any of these areas, a borrower may still be considered for a 1 rating, if fully secured by cash, or properly margined, listed stock, investment grade corporate bonds or U.S. Government Securities, (125% collateral value to loan commitment).

A loan rated 2 would include borrowers who are somewhat more of a credit risk than a 1 rated borrower and therefore require more frequent monitoring. Those borrowers would have the following qualities: cash flow has been and is expected to be adequate to meet debt service requirements; financial statement is current, of good quality and in adequate detail; financial condition of company compares favorably with the industry averages; earnings are generally stable; borrower consistently adheres to repayment schedule for both principal and interest and covenants; management integrity and ability is considered sound; and industry outlook is acceptable.

Loans rated 3 include credits whose performance is generally stable. Also included in this category are credits where the guarantor is sufficiently strong to support operating losses and has demonstrated a willingness to do so. Additionally, loans risk rated 3 may include the following qualities: borrower's business is tied to more economically sensitive industries; borrower may have violated one or more financial covenants; occasional requirements for waivers, or amendments may occur, however liquidity and capitalization are expected to continue to be acceptable; integrity of management is acceptable but ability remains to be proven; borrower may not compare well to industry standards; relationship requires a high level of monitoring due to its complexity. Also, financial data of affiliates may not be available or difficult to track; borrower may not provide sufficient documentation for confirming all taxable income/losses but consistently adheres to repayment schedules for both principal and interest. Also, borrower may report a high level of contingent liabilities.

Loans rated 4 would include credits which demonstrate any or all of the following criteria: borrower's or guarantor's financial performance shows negative trends and yet cash flow remains still adequate to repay debt; loans which continue to pay as agreed but the Bank has not received current financial statements to confirm repayment ability and to enable management to complete a timely annual review; most commercial construction loans; loan has been processed through automated underwriting and does not meet management's scoring threshold; loans to start-up companies until the borrower's have achieved stabilized operations (i.e., 1-3 years); and loans recommended for upgrade from problem loan status (5 through 8) would generally pass through the watch category for 6 months to a year unless there are sufficient reasons to bypass the watch rating and be upgraded to a 3 or higher.

Loans risk rated 5 are currently protected but are potentially weak. These loans, in management's judgment, constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances surrounding a specific asset. Loans in this category have potential weaknesses which may, if not checked or corrected, weaken the loan or inadequately protect the Bank's credit position at some future date. This might include loans which the lending officer may be unable to supervise properly because of: lack of expertise, inadequate loan agreement, the poor condition of or lack of control over collateral, failure to obtain proper documentation or any other deviations from prudent lending practices. Economic or market conditions which may, in the future, affect the obligor may warrant special mention of the asset. Loans for which an adverse trend in the borrower's operations or an imbalanced position in the balance sheet which has not reached a point where the liquidation is jeopardized may be included in this classification.

Loans risk rated 6 are considered substandard. A substandard loan is inadequately protected by the sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual loans classified substandard. Residential mortgages are not subject to substandard classification unless the following well defined weaknesses have occurred: the ability of the borrower to repay the debt is questionable as evidenced by delinquency of 90 days, and repayment of the debt is dependent on the sale of the underlying real estate. A consumer loan is considered a substandard asset only when it is 90 days past due.

Loans risk rated 7 are categorized as doubtful. These loans have all the weaknesses inherent in one classified 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. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans. The entire amount of the loan might not be classified as doubtful when collection of a specific portion appears highly probable. Loans are generally not classified doubtful for an extended period of time (i.e., over a year).

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Loans classified 8, or loss, are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. Losses are taken in the period in which they surface as uncollectible.

Loans in category 9 and unrated are evaluated for credit quality after origination principally based upon delinquency status, but may also include credit scores and collateral valuations.

The following tables present the loan portfolio as of December 31, 2012 and December 31, 2011 by credit quality indicator (in thousands). Except for loans in the 9 and unrated categories, credit quality indicators are reassessed for each applicable loan at least annually, generally upon the anniversary of the loan's origination or receipt and analysis of the borrower's financial statements, when applicable, or in the event that information becomes available that would cause us to re-evaluate.

Credit Quality Indicator Analysis as of December 31, 2012

	Commercial and industrial	Commercial mortgage	Residential mortgage - first position	Residential mortgage - second position	Consumer - indirect	Consumer - other	Loans held for sale	Deferred Fees and Costs	Total
1-Superior	\$ 15,422	-	-	-	-	386	-	-	15,808
2-Good	15,422	28,236	1,409	-	-	974	-	-	46,041
3-Satisfactory	76,473	219,748	1,506	253	-	-	-	-	297,980
4-Watch	44,633	213,267	6,192	389	-	-	-	-	264,481
5-Special Mention	9,527	21,581	-	-	-	-	-	-	31,108
6-Substandard	17,164	16,895	5,063	377	-	-	-	-	39,499
7-Doubtful	-	-	-	-	-	-	-	-	-
8-Loss	-	-	-	-	-	-	-	-	-
Subtotal	\$ 178,641	499,727	14,170	1,019	-	1,360	-	-	694,917
9 and not rated	34,826	25,686	272,802	99,080	283,836	16,963	21,113	9,549	763,855
Total	\$ 213,467	525,413	286,972	100,099	283,836	18,323	21,113	9,549	1,458,772

Credit Quality Indicator Analysis as of December 31, 2011

	Commercial and industrial	Commercial mortgage	Residential mortgage - first position	Residential mortgage - second position	Consumer - indirect	Consumer - other	Loans held for sale	Deferred Fees and Costs	Total
1-Superior	\$ 9,814	105	-	-	-	913	-	-	10,832
2-Good	8,826	26,195	1,718	2,560	-	-	-	-	39,299
3-Satisfactory	68,246	177,882	1,409	576	-	-	-	-	248,113
4-Watch	43,928	210,901	6,045	269	-	-	-	-	261,143
5-Special Mention	7,864	4,645	1,127	-	-	-	-	-	13,636
6-Substandard	29,440	30,018	4,496	453	-	100	-	-	64,507
7-Doubtful	-	-	-	7	-	-	-	-	7
8-Loss	-	-	-	-	-	-	-	-	-
Subtotal	\$ 168,118	449,746	14,795	3,865	-	1,013	-	-	637,537
9 and not rated	30,626	17,667	241,378	98,012	227,541	24,570	7,556	7,634	654,984
Total	\$ 198,744	467,413	256,173	101,877	227,541	25,583	7,556	7,634	1,292,521

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The table below presents a summary of information regarding nonaccruing loans and other nonperforming assets as of the end of the respective periods (in thousands):

	<u>December 31, 2012</u>	<u>December 31, 2011</u>	<u>December 31, 2010</u>
Accruing loans 90 days or more delinquent	\$ 722	969	1,589
Nonaccruing loans	<u>17,770</u>	<u>17,307</u>	<u>21,243</u>
Total nonperforming loans	18,492	18,276	22,832
Other real estate owned	3,759	4,632	4,291
(less write-down of other real estate owned)	<u>(203)</u>	<u>(397)</u>	<u>(551)</u>
Total nonperforming assets	<u>\$ 22,048</u>	<u>22,511</u>	<u>26,572</u>

The following tables present, as of December 31, 2012 and December 31, 2011, additional details about the loan portfolio in the form of an aging analysis. Amounts exclude deferred fees and costs (in thousands).

Aging Analysis as of December 31, 2012

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days Or Greater</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>> 90 Days and Accruing</u>	<u>Non-Accrual Loans</u>
Commercial and industrial	\$ 2,478	3,811	2,475	8,764	204,703	213,467	46	2,429
Commercial mortgages	1,365	1,167	10,116	12,648	512,765	525,413	-	10,116
Residential - first lien	4,369	1,013	5,048	10,430	276,542	286,972	201	4,847
Residential - junior lien	616	511	427	1,554	98,545	100,099	49	378
Consumer:								
Automobile - indirect	2,758	701	412	3,871	279,965	283,836	412	-
Other	308	114	14	436	17,887	18,323	14	-
Loans held-for-sale	-	-	-	-	21,113	21,113	-	-
	<u>\$ 11,894</u>	<u>7,317</u>	<u>18,492</u>	<u>37,703</u>	<u>1,411,520</u>	<u>1,449,223</u>	<u>722</u>	<u>17,770</u>

Aging Analysis as of December 31, 2011

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days Or Greater</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>> 90 Days and Accruing</u>	<u>Non-Accrual Loans</u>
Commercial and industrial	\$ 395	432	3,992	4,819	193,925	198,744	75	3,917
Commercial mortgages	2,184	-	9,078	11,262	456,151	467,413	-	9,078
Residential - first lien	633	55	4,453	5,141	251,032	256,173	652	3,801
Residential - junior lien	444	91	419	954	100,923	101,877	8	411
Consumer:								
Automobile - indirect	1,766	653	165	2,584	224,957	227,541	165	-
Other	257	88	169	514	25,069	25,583	69	100
Loans held-for-sale	-	-	-	-	7,556	7,556	-	-
Total	<u>\$ 5,679</u>	<u>1,319</u>	<u>18,276</u>	<u>25,274</u>	<u>1,259,613</u>	<u>1,284,887</u>	<u>969</u>	<u>17,307</u>

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A summary of information regarding impaired loans follows (in thousands):

	As of and for the year ended December 31, 2012	As of and for the year ended December 31, 2011	As of and for the year ended December 31, 2010
Recorded investment at period end	\$ 17,770	17,307	21,655
Impaired loans with specific related allowance at period end	\$ 1,200	2,453	3,116
Amount of specific related allowance at period end	\$ 603	1,138	674
Average investment during the period	\$ 19,014	20,394	21,862
Interest income recognized on a cash basis during the period	\$ 433	127	35
Interest income forgone on impaired loans	\$ 596	743	429

The details of impaired loans as of December 31, 2012 and December 31, 2011 follow (in thousands):

December 31, 2012

	Recorded Investment	Unpaid Principal Balance	Specific Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance					
Commercial and industrial	\$ 1,592	2,042	-	1,604	202
Commercial mortgage	9,753	11,407	-	8,830	112
Residential mortgage - first position	4,847	5,110	-	4,663	84
Residential mortgage - second position	378	391	-	329	33
Consumer - other	-	-	-	-	2
Subtotal	<u>16,570</u>	<u>18,950</u>	<u>-</u>	<u>15,426</u>	<u>433</u>
With specific allowance					
Commercial and industrial	837	924	515	1,759	-
Commercial mortgage	363	445	88	1,829	-
Residential mortgage - first position	-	-	-	-	-
Residential mortgage - second position	-	-	-	-	-
Consumer - other	-	-	-	-	-
Subtotal	<u>1,200</u>	<u>1,369</u>	<u>603</u>	<u>3,588</u>	<u>-</u>
Total	<u>\$ 17,770</u>	<u>20,319</u>	<u>603</u>	<u>19,014</u>	<u>433</u>
Summary by portfolio:					
Commercial	\$ 12,545	14,818	603	14,022	314
Residential	5,225	5,501	-	4,992	117
Consumer and other	-	-	-	-	2
Total	<u>\$ 17,770</u>	<u>20,319</u>	<u>603</u>	<u>19,014</u>	<u>433</u>

December 31, 2011

	Recorded Investment	Unpaid Principal Balance	Specific Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance					
Commercial and industrial	\$ 2,541	3,048	-	1,401	-
Commercial mortgage	8,001	9,440	-	6,578	114
Residential mortgage - first position	3,801	3,968	-	3,366	13
Residential mortgage - second position	411	439	-	390	-
Consumer - other	100	102	-	76	-
Subtotal	<u>14,854</u>	<u>16,997</u>	<u>-</u>	<u>11,811</u>	<u>127</u>
With specific allowance					
Commercial and industrial	1,376	1,454	895	3,079	-
Commercial mortgage	1,077	1,153	243	3,988	-
Residential mortgage - first position	-	-	-	1,265	-
Residential mortgage - second position	-	-	-	201	-
Consumer - other	-	-	-	50	-
Subtotal	<u>2,453</u>	<u>2,607</u>	<u>1,138</u>	<u>8,583</u>	<u>-</u>
Total	<u>\$ 17,307</u>	<u>19,604</u>	<u>1,138</u>	<u>20,394</u>	<u>127</u>
Summary by portfolio:					
Commercial	\$ 12,995	15,095	1,138	15,046	114
Residential	4,212	4,407	-	5,222	13
Consumer and other	100	102	-	126	-
Total	<u>\$ 17,307</u>	<u>19,604</u>	<u>1,138</u>	<u>20,394</u>	<u>127</u>

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Troubled Debt Restructurings

As of December 31, 2012, there was one commercial relationship totaling \$4.3 million that was considered a TDR due to the nature of the concessions granted to the borrower. We have established no impairment reserve for the relationship in light of the value of underlying collateral and management's recovery expectations. The balances of the underlying loans are included in non-performing loans. For this relationship, we renegotiated certain terms of their loans in 2010. The significant term modified was the monthly principal and interest payment amount. We agreed to forbear our rights under default provisions in the loan agreements on the condition that the borrower made monthly payments which were significantly less than those required under the terms of the original loan agreements. The customer was in compliance with the terms of the forbearance agreement which expired in March 2011. At that time, we renewed the forbearance agreement for an additional 24 months with higher monthly payments than under the previous agreement. To date, the borrower has paid as agreed.

A loan totaling \$0.3 million, previously classified as a TDR was paid-off in the second quarter of 2012.

(5) Premises and Equipment

A summary of premises and equipment at December 31, 2012, and 2011, follows (in thousands):

	<u>2012</u>	<u>2011</u>
Land and land improvements	\$ 948	948
Buildings and leasehold improvements	24,750	24,172
Furniture, fixtures and equipment	<u>20,878</u>	<u>19,520</u>
	46,576	44,640
Less accumulated depreciation and amortization	<u>31,457</u>	<u>28,539</u>
Premises and equipment - net	<u>\$ 15,119</u>	<u>16,101</u>

Depreciation and amortization expense amounted to \$2,550,000, \$2,419,000, and \$2,099,000, for the years ended December 31, 2012, 2011, and 2010, respectively.

In June 2008, the Company completed the sale and subsequent lease-back of six banking offices. The gross gain of \$1,558,000 was deferred and included in Accrued Interest Payable and Other Liabilities in the Consolidated Balance Sheet and is amortized as a credit to Occupancy expenses on a straight-line basis for 15 years through 2023, the term of the underlying leases.

(6) Loan Servicing Assets

Changes in loan servicing assets for each of the years presented, and the respective period-end estimated fair values were as follows (in thousands):

	<u>2012</u>		<u>2011</u>		<u>2010</u>	
	<u>Book Value</u>	<u>Estimated Fair Value</u>	<u>Book Value</u>	<u>Estimated Fair Value</u>	<u>Book Value</u>	<u>Estimated Fair Value</u>
Balance at January 1,	\$ 2,489	\$ 3,244	\$ 2,222	\$ 3,418	\$ 1,797	\$ 2,893
Originations	1,332		762		914	
Amortization	(600)		(495)		(489)	
Balance at December 31,	<u>\$ 3,221</u>	<u>\$ 3,382</u>	<u>\$ 2,489</u>	<u>\$ 3,244</u>	<u>\$ 2,222</u>	<u>\$ 3,418</u>

Included in Loan servicing income, net, are gross servicing fees earned of \$1,477,000, \$1,410,000, and \$1,355,000, for the years ended December 31, 2012, 2011, and 2010, respectively. Amortization expense of loan servicing assets for the next five years is estimated to be \$674,000, \$663,000, \$645,000, \$509,000, and \$372,000.

The estimated fair value of loan servicing rights may vary significantly in subsequent periods due to changing interest rates and the effect thereof on prepayment speeds. Additionally, estimated fair value assumes there are a willing buyer and willing seller in the transaction. Management does not intend to sell these servicing rights.

The key economic assumptions used to determine the fair value of loan servicing rights at December 31, 2012 and 2011 were a discount rate of 10.00% and 9.00%, respectively, in each year and weighted average portfolio maturity of 19.6 years in 2012 and 19.3 years in 2011. The sensitivity of fair value to changes in certain portfolio characteristics at each year end are

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summarized in the table that follows (dollars in thousands). These calculated sensitivities are hypothetical, and actual changes in the fair value of loan servicing rights may differ significantly from the amounts presented herein. The effect of a variation in a particular assumption or characteristic on the fair value of the servicing rights is calculated without changing any other assumption. However, in practice, changes in one factor may result in changes in another which may magnify or counteract the sensitivities. The changes in assumptions are presumed to be instantaneous.

	<u>2012</u>	<u>2011</u>
Weighted-average prepayment speed	338 %	326 %
Impact on fair value of 20% adverse change	\$ (268)	\$ (278)
Impact on fair value of 20% positive change	376	371
Weighted-average current coupon for similar loans	4.07 %	4.74 %
Impact on fair value of 100 basis point adverse change	\$ (591)	\$ (695)
Impact on fair value of 100 basis point positive change	698	602

(7) Time Deposits

At December 31, 2012, the scheduled maturity of time deposits was as follows (in thousands):

2013	\$ 234,774
2014	97,201
2015	38,204
2016	161
2017	<u>13</u>
	<u>\$ 370,353</u>

Time deposits of \$100,000 or more amounted to \$157,589,000 at December 31, 2012, and \$165,311,000 at December 31, 2011. Interest expense on all time deposits of \$100,000 or more was as follows: \$1,678,000 in 2012, \$2,737,000 in 2011, and \$4,118,000 in 2010.

(8) Borrowings

Borrowings at December 31, 2012 included, net of discount, a \$3.5 million non-interest bearing payment due November 19, 2013 for the acquisition of OBS, and a \$0.9 million non-interest bearing contingent payment with no stated maturity. At December 31, 2011, borrowings included, net of discount, a \$6.0 million of non-interest bearing payments for the acquisition of OBS, and a \$1.0 million non-interest bearing contingent payment with no stated maturity. There were no short-term borrowings during 2012 or 2011.

The following table presents information about the Company's formal available lines of credit and related loan collateral at December 31, 2012 (in thousands). Amounts utilized include borrowings, and undrawn letters of credit in the Company's favor of \$2,389,000.

	<u>Amount Utilized</u>	<u>Unused</u>	<u>Collateralized by</u>	<u>Carrying Value of Collateral</u>
Federal Home Loan Bank of New York	\$ 2,389	\$ 232,646	Residential mortgages	\$ 168,817
			Commercial mortgages	\$ 66,218
			FHLB stock	\$ 1,604
Federal Reserve Bank of New York	\$ -	\$ 460,020	Indirect automobile loans	\$ 272,208
			Commercial loans and mortgages	\$ 364,012

Advances under the overnight line of credit with the FHLB of New York are payable on demand and generally bear interest at the federal funds rate plus .10%. The Company also has access to the FHLB's Term Advance Program, which allows the Bank to borrow up to \$100,000,000 at various terms and rates, subject to the Bank's pledging of eligible collateral. Advances under the Federal Reserve Bank of New York are payable the following business day and bear interest at the Federal Reserve Bank of New York's discount rate for primary credit, which is generally 0.25% to 1.00% above the target federal funds rate.

(9) Junior Subordinated Debentures and Interest Rate Swap Agreements

In September 2007, the Company issued \$20,619,000 of unsecured, 30-year junior subordinated deferrable interest debentures (T3) through a wholly-owned business trust. The debentures carried a fixed interest rate of 6.32% per annum through December 2012, floating thereafter for twenty-five years at LIBOR plus 1.44% (1.748% at December 31, 2012) per annum, adjustable quarterly. Interest is payable quarterly. The debentures' final maturity is December 2037, and is callable, in whole or in part, at par beginning December 2012 at the Company's option, and subject to Federal Reserve Bank of New York approval. Interest payments can be deferred for up to five years, but would restrict the Company's ability to pay dividends. At December 31, 2012, these debentures were considered Tier I for regulatory purposes.

In December 2012, the Company became exposed to interest rate risk as a result of the timing of changes in interest rates associated with T3. In consideration of the end of the fixed-rate period, the Company entered into a forward interest rate swap agreement on December 22, 2011. The Company designated the swap as a cash flow hedge, and it is intended to protect against the variability of cash flows associated with this debenture. This swap became effective on December 15, 2012 and expires on December 15, 2022. This interest rate swap agreement modifies the repricing characteristics of the debenture from a floating-rate debt (LIBOR +1.44%) to a fixed-rate debt (3.859%).

In June, 2006, the Company issued \$30,928,000 of unsecured, 30-year floating rate junior subordinated deferrable interest debentures (T2) through a wholly-owned business trust. The debentures carry an interest rate of 3-month LIBOR plus 1.40% (1.708% at December 31, 2012). Interest is payable quarterly. The debentures' final maturity is June 2036, and is callable, in whole or in part, at par after June 2012 at the Company's option, and subject to Federal Reserve Bank of New York approval. Interest payments can be deferred for up to five years, but would restrict the Company's ability to pay dividends. At December 31, 2012, these debentures were considered Tier I capital of the Company.

The Company is exposed to interest rate risk as a result of both the timing of changes in interest rates of assets and liabilities, and the magnitude of those changes. In order to reduce this risk for T2, the Company entered into an interest rate swap agreement in 2007, which expired on June 15, 2011. This interest rate swap agreement modified the repricing characteristics of the debentures from a floating-rate debt (LIBOR +1.40%) to a fixed-rate debt (5.54%). For this swap agreement, amounts receivable or payable were recognized as accrued under the terms of the agreement, and the net differential was recorded as an adjustment to interest expense of the related debentures. The interest rate swap agreement was designated as a cash flow hedge. Therefore, the effective portion of the swap's unrealized gain or loss was recorded as a component of other comprehensive income. The ineffective portion of the unrealized gain or loss, if any, was immediately reported in other operating income. The swap agreement was carried at fair value in Other Liabilities on the Consolidated Statement of Condition.

In consideration of the expiration of the aforementioned agreement, the Company entered into a forward interest rate swap agreement on July 1, 2010. This swap became effective on June 15, 2011 and expires on June 15, 2021. This interest rate swap agreement modifies the repricing characteristics of T2 from a floating-rate debt (LIBOR +1.40%) to a fixed-rate debt (4.81%). The accounting for this is the same as the expired swap agreement.

(10) Income Taxes

Total income taxes for the each of the years ended December 31, were allocated as follows (in thousands):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Income from operations	\$ 8,434	6,178	6,205
Stock option exercise included in stockholders' equity	(1,122)	-	(232)
Change in stockholders' equity for unrealized gain (loss) on securities available for sale	(329)	180	(483)
Change in stockholders' equity for unrealized gain (loss) on fair value of interest rate swap	<u>(760)</u>	<u>(1,341)</u>	<u>180</u>
	<u>\$ 6,223</u>	<u>5,017</u>	<u>5,670</u>

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The components of income tax expense (benefit) relating to income from operations follow (in thousands):

	Years ended December 31,		
	2012	2011	2010
Current:			
Federal	\$ 8,260	5,706	5,882
State	1,502	1,046	1,086
	9,762	6,752	6,968
Deferred:			
Federal	(1,262)	(347)	(513)
State	(66)	(227)	(250)
	(1,328)	(574)	(763)
	\$ 8,434	6,178	6,205

Income tax expense differed from the amounts computed by applying the applicable U.S. Federal corporate tax rates to pretax income from operations as follows (dollars in thousands):

	Years ended December 31,		
	2012	2011	2010
Tax expense at statutory rate of 35%	\$ 9,468	7,841	8,351
Tax-exempt interest	(1,991)	(2,251)	(2,487)
Interest expense disallowance	48	78	117
State taxes, net of Federal benefit	933	532	543
Nondeductible operating expenses	59	62	33
Change in valuation allowance for deferred tax assets	(2)	(2)	(2)
Recovery of state allowance for loan losses	-	-	(167)
Other	(81)	(82)	(183)
	\$ 8,434	6,178	6,205
Total			
Effective tax rate	31.2%	28.0%	26.0%

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

	<u>2012</u>	<u>2011</u>
Deferred tax assets:		
Allowance for loan losses - books	\$ 6,861	6,377
Incentive stock and retirement plans	2,387	1,825
Stock options	75	75
Interest on nonaccrual loans	1,054	1,065
Retirement and other reserves	44	44
Gain on sale of premises and equipment – books	612	671
Write-down of available-for-sale securities	184	184
Minority-owned entities	343	285
Net unrealized loss on interest rate swap	2,482	1,722
Other	<u>197</u>	<u>342</u>
Deferred tax assets before allowance	14,239	12,590
Valuation allowance	<u>(76)</u>	<u>(78)</u>
Deferred tax assets	<u>14,163</u>	<u>12,512</u>
Deferred tax liabilities:		
Loan servicing rights	1,276	986
Intangible assets	1,262	1,390
Depreciation	370	969
Net unrealized gain on available for sale securities	<u>495</u>	<u>833</u>
Deferred tax liabilities	<u>3,403</u>	<u>4,178</u>
Net deferred tax asset	<u>\$ 10,760</u>	<u>8,334</u>

Realization of deferred tax assets is dependent upon the generation of future taxable income or the existence of sufficient taxable income within the carryback period. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax assets will not be realized. In assessing the need for a valuation allowance, management considers the scheduled reversal of deferred tax liabilities, the level of historical taxable income, and projected future taxable income over the periods in which the temporary differences comprising the deferred tax assets are deductible. Based on its assessment, management determined that no valuation allowance was needed except for that related to its nonbank subsidiaries' mortgage tax credits.

No material amount of interest expense was recognized during 2012 or 2011 for any unrecognized tax benefits. The Company is not subject to U.S. Federal tax examinations or state tax examinations for years before 2010.

(11) Stockholder's Equity

Payment of dividends by the Bank to the Company is limited or restricted in certain circumstances. According to federal banking law, the approval of the Office of the Comptroller of the Currency (OCC) is required for the declaration of dividends in any year in which dividends exceed the total of net income for that year plus retained income for the preceding two years. At December 31, 2012, approximately \$27,721,000 was available for dividends to the Company without the approval of the OCC. Payment of dividends by the Company's non-bank subsidiaries is also restricted by their respective regulatory agencies. The amount of dividends available for payment by these companies without regulatory approval is insignificant.

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(12) Earnings Per Share

Basic and diluted earnings per share for the years ended December 31, 2012, 2011, and 2010, were computed as follows (dollars in thousands, except share and per-share data):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Basic Earnings Per Share:			
Net income applicable to common shareholders	\$ 18,837	16,312	17,656
Weighted average common shares outstanding	<u>1,887,102</u>	<u>1,888,229</u>	<u>1,888,080</u>
Basic earnings per share	<u>\$ 9.98</u>	<u>8.64</u>	<u>9.35</u>
Diluted Earnings Per Share:			
Net income applicable to common shareholders	\$ 18,837	16,312	17,656
Weighted average common shares outstanding	1,887,102	1,888,229	1,888,080
Effect of assumed exercise of stock options	<u>42,258</u>	<u>35,548</u>	<u>31,112</u>
Total	<u>1,929,360</u>	<u>1,923,777</u>	<u>1,919,192</u>
Diluted earnings per share	<u>\$ 9.76</u>	<u>8.48</u>	<u>9.20</u>

(13) Retirement Plans

Retirement Plans

The Company has a combined profit sharing and 401(k) plan covering substantially all Bank employees and a 401(k) plan for non-Bank employees upon completion of 1,000 hours of service. Contributions to the Bank plan are determined by a mathematical formula which takes into account average net income of the Bank for the current and prior year, the level of the Bank's stockholders' equity and average Bank employee compensation. Both plans are subject to a minimum contribution of 3% of eligible compensation. It is the Company's policy to annually fund current costs as they accrue. Expenses of these plans amounted to \$3,165,000, \$2,841,000, and \$2,480,000, for the years ended December 31, 2012, 2011, and 2010, respectively.

Employee Stock Ownership Plan

The Company has an employee stock ownership plan (ESOP) for employees of the Company. Annual contributions are made at the discretion of the Board of Directors. ESOP expense amounted to \$281,000, \$266,000, and \$220,000, for the years ended December 31, 2012, 2011, and 2010, respectively. Shares distributed to a participant upon termination of service are subject to a put option whereby the participant may cause the Plan's Trust to purchase the shares at fair value. At December 31, 2012, and 2011, the plan held 31,405 and 29,995 shares with an estimated fair value, at the respective dates, of \$4,429,000 and \$3,876,000.

Supplemental Executive Retirement Plans

The Company has two un-funded, non-qualified, supplemental executive retirement plans (SERP) covering certain executives designed to compensate for the portion of cash compensation unable to be included in the profit sharing and 401(k) plan, because of limitations in the plan's design and in the Internal Revenue Code. The Company had accrued a liability of \$795,000 and \$718,000 at December 31, 2012 and 2011, respectively, for these SERPs. Expenses of these plans amounted to \$144,000 in 2012, a credit of \$31,000 for 2011, and expense of \$162,000, and in 2010.

(14) Stock-Based Compensation Plans

The Company has two stock-based compensation plans (Stock Option Plan and Stock Appreciation Rights Plan) for executives, which are described below. Amounts recognized in the Consolidated Financial Statements with respect to these plans are as follows (in thousands):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Stock option plan	\$ -	-	-
Stock appreciation rights plan	<u>2,352</u>	<u>3,124</u>	<u>606</u>
Pre-tax cost of plans included in salaries and employee benefits expenses	<u>\$ 2,352</u>	<u>3,124</u>	<u>606</u>
Amount of related income tax recognized in income	<u>\$ (941)</u>	<u>(1,250)</u>	<u>(242)</u>

The significant increase in costs of the stock appreciation rights plan in both 2012 and 2011 were a result of increases in the market value of the Company's common stock.

Stock Option Plan

The Company's stock option plan authorized grants of options to purchase up to 192,000 shares of common stock. All 192,000 options available were granted by year-end 2004. There are no future expenses associated with the unvested options. The options were granted with an exercise price equal to the fair value of the common stock on the grant date based on the most recent public stock sale known to the Company immediately preceding the grant. The options are exercisable either five years from the date of grant, or at the later of age 55 or 15 years of continuous employment with the Company, or at normal retirement age (65).

The following summarizes outstanding and exercisable options at December 31, 2012:

	2012	
	# Shares Subject to Options	Weighted Average Exercise Price
Options outstanding at beginning of the year	106,542	\$ 42.25
Granted	-	-
Exercised	27,700	45.13
Expired	1,516	73.46
Options outstanding at year end	77,326	\$ 43.35
Options exercisable at year end	63,610	\$ 41.97
Options available for future grants	none	

At December 31, 2012, the intrinsic value of all outstanding options was approximately \$7,553,000, while the intrinsic value of vested options included in this total was approximately \$6,301,000. No options were exercised in 2011. The intrinsic value of options exercised during the years ended December 31, 2012 and 2010 were \$2,832,000 and \$585,000, respectively. No options vested in 2012, 2011 or 2010.

Options outstanding (both exercisable and unexercisable) at December 31, 2012, had exercise prices ranging from \$30.04 to \$73.46. The weighted average expected life of the options is four years. Since the options have no stated expiration date, the expected life is calculated as the number of years from grant date to the grantee's 65th birthday.

The source of shares issued upon exercise has historically been, and is expected to be, treasury shares. From time to time, the Company expects to purchase shares for treasury to be used for these exercises. The amount of shares, timing and cost of these purchases cannot be determined, as the Company does not know when and in what quantity participants will exercise their options.

Stock Appreciation Rights Plan

The Company has an incentive stock appreciation rights plan for executives which allows for the award of Stock Appreciation Rights (SAR) awards. The number of awards issued is based upon return on beginning equity in each year. SARs represent the right to receive payment in cash or stock, at the Compensation Committee of the Board of Director's option, equal to the amount, if any, by which the market value per share of common stock on the date of exercise exceeds the SARs grant price. Long-term SARs are exercisable at the later of age 55 or 15 years of continuous employment with the Company or at normal retirement age (65). Medium-term SARs are exercisable five years from the date of grant or upon retirement. The following summarizes the activity of these awards as of and for the year ended December 31, 2012.

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	Long-term SARs		Medium-term SARs	
	#	Weighted Average Grant Price	#	Weighted Average Grant Price
Awards outstanding, January 1, 2012	97,684	\$ 88.24	62,194	\$ 88.82
Granted	15,781	\$ 129.22	10,521	\$ 129.22
Exercised	7,403	\$ 92.35	5,136	\$ 86.77
Forfeited	-	\$ -	6,799	\$ 88.27
Expired	-	\$ -	-	\$ -
Awards outstanding at December 31, 2012	106,062	\$ 94.05	60,780	\$ 96.05
Awards exercisable at December 31, 2012	50,705	\$ 92.56	5,786	\$ 87.68

In February 2012, certain executives were awarded a total of 15,781 long-term SARs and 10,521 medium-term SARs, all at a grant price of \$129.22 per share, the then-current market value (based on the most recent public stock sale known to the Company immediately preceding the effective grant date) of the Company's common stock.

During 2012, 7,403 long-term SARs were exercised with a fair value of \$399,000, and 5,136 medium-term SARs were exercised with a fair value of \$314,000. No awards were exercised in 2011 or 2010. The fair value of awards vested during years ended December 31, 2012 and 2011 amounted to \$796,000 and \$182,000, respectively.

The weighted average estimated per-award fair values, as of December 31, 2012 and 2011 are presented below. Fair value was estimated using the Black-Scholes-Merton option-pricing model with the following assumptions. No forfeitures are assumed, as generally none are anticipated.

Award Type	2012		2011	
	LTS	MTS	LTS	MTS
Per-award fair value	\$37.29	\$35.51	\$29.71	\$29.19
Expected dividend yield	2.12%	2.12%	2.58%	2.58%
Risk-free interest rate	0.72%	0.72%	0.91%	0.91%
Expected Life	5.0 years	5.0 years	5.0 years	5.0 years
Volatility	10.00%	10.00%	8.23%	8.23%

Long-term SAR's outstanding and medium-term SARs outstanding (both exercisable and unexercisable) at December 31, 2012, had exercise prices ranging from \$78.98 to \$129.22. The weighted average expected life of these awards is five years. Since these awards have no stated expiration date, the expected life is calculated as the number of years from grant date to the grantee's 60th birthday, which is the historical life for similar past awards. Based upon current assumptions, the estimated compensation cost related to non-vested awards not yet recognized is \$1,857,000, which is expected to be recognized over a weighted average period of five years. The Company had accrued a liability of \$5,230,000 and \$3,887,000 at December 31, 2012 and 2011, respectively, representing the accumulated fair-value vested obligation of these awards under the plan.

(15) Leases

The Company leases certain buildings and office space under operating lease arrangements. Rent expense, net of rent received and deferred-gain on sale-leaseback, under these arrangements amounted to \$2,430,000 in 2012, \$2,358,000 in 2011, and \$2,148,000 in 2010. Real estate taxes, insurance, maintenance, and other operating expenses associated with leased buildings and office space are generally paid by the Company.

A summary of non-cancellable, long-term operating lease commitments as of December 31, 2012, follows (in thousands):

Years ending December 31,	Amount
2013	\$ 2,465
2014	2,421
2015	2,316
2016	2,301
2017	2,297
2018 and after	9,516
Total	\$ 21,316

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(16) Commitments and Contingencies

In the normal course of business, various commitments and contingent liabilities are outstanding. The following table presents the notional amount of the Company's significant commitments and their respective carrying amount, where applicable. Most of these commitments are not included in the Company's Consolidated Balance Sheet (in thousands).

	Year ended December 31,			
	2012		2011	
	Notional Amount	Carrying Amount	Notional Amount	Carrying Amount
Commitments to extend credit:				
Commercial lines of credit	\$ 134,054	-	123,749	-
Commercial real estate and construction	\$ 36,257	-	37,174	-
Residential real estate at fixed rates	\$ 5,261	-	5,269	-
Home equity lines of credit	\$ 210,236	-	186,902	-
Unsecured personal lines of credit	\$ 23,492	-	16,326	-
Standby and commercial letters of credit	\$ 13,100	(192)	15,563	(233)
Commitments to sell real estate loans	\$ 21,113	-	7,556	-

Commitments to extend credit are agreements to lend to customers and generally have fixed expiration dates or other termination clauses that may require payment of a fee, the amount of which is immaterial. Standby and commercial letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party and also require payment of a fee. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of an underlying contract with a third party, whereas commercial letters of credit are issued to facilitate commerce and typically result in the commitment being funded when the underlying transaction is consummated between the customer and third party. Because many commitments and almost all letters of credit expire without being funded in whole or in part, the notional amounts are not estimates of future cash flows. The credit risk associated with commitments to extend credit and standby and commercial letters of credit is essentially the same as that involved with extending loans to customers and is subject to normal credit policies. The Company's credit policy generally requires customers to provide collateral, usually in the form of customers' operating assets or property, prior to disbursement of approved loans.

Commitments to originate fixed-rate loans are made when a borrower executes a rate-lock agreement. At the time of execution, the Company generally charges a rate-lock fee, which approximates the fair value of the Company's commitment. These commitments usually have terms ranging from 30 to 45 days. Concurrently, the Company enters into commitments to sell certain fixed-rate residential real estate loans (usually those subject to the foregoing rate-locks). These commitments to sell are recorded in the consolidated balance sheet at estimated fair value.

The Company has committed \$3,000,000 as a limited partnership investment to Cephaz Capital Partners, II. This Small Business Investment Company (SBIC) is a community-bank backed mezzanine finance company. It is a follow-on investment to our current investment in Cephaz Capital Partners. At December 31, 2012, the Company had a remaining unfunded commitment of \$1,500,000. This investment is carried in Other Assets on the Consolidated Balance Sheet.

The Company has committed \$500,000 for an investment in Trillium Lakefront Partners, LLC. This venture capital fund is a community-backed initiative in support of new business and job growth in the Company's market area. At December 31, 2012, the Company had a remaining unfunded commitment of less than \$100,000. This investment is carried in Other Assets on the Consolidated Balance Sheet.

As discussed in Note 2 under the terms of the OBS purchase agreement, OBS is obligated to make future payments totaling \$4,367,000, of which \$3,500,000 is due in November 2013.

In the normal course of business, the Company has various contingent liabilities outstanding that are not included in the Consolidated Financial Statements. Management does not anticipate any material losses as a result of these contingent liabilities.

(17) Regulatory Matters

The Company and its subsidiaries are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and its subsidiaries must meet specific capital guidelines that involve quantitative measures of the Company's and Bank's assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. The capital amounts and classifications are also

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subject to qualitative judgments by regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios (as set forth in the table following) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital to average assets (as defined). Management believes, as of December 31, 2012, that the Company and Bank met all capital adequacy requirements to which they are subject. The Company's trust subsidiaries, Genesee Valley Trust Company and Canandaigua National Trust Company of Florida, must also meet minimum capital requirements as set forth by their regulators. As of December 31, 2012, these companies complied with their minimum capital requirements.

As of December 31, 2012, and as of the most recent notification from regulators, the Company and the Bank are well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the Company and Bank must maintain a minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. Subsequently, there have been no conditions or events which management believes has changed the Company's or Bank's category.

Regulatory Capital as of December 31, 2012						
(Dollars in thousands)	Actual Regulatory Capital		Minimum Requirement		Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Leverage capital (Tier 1) as percent of						
three-month average assets:						
Company	\$ 176,738	9.59 %	\$ 73,745	4.00 %	\$ 92,181	5.00 %
Bank	\$ 155,695	8.51 %	\$ 73,175	4.00 %	\$ 91,469	5.00 %
As percent of risk-weighted, period-end assets						
Core capital (Tier 1)						
Company	\$ 176,738	11.77 %	\$ 60,068	4.00 %	\$ 90,102	6.00 %
Bank	\$ 155,695	10.57 %	\$ 58,937	4.00 %	\$ 88,405	6.00 %
Total capital (Tiers 1 and 2)						
Company	\$ 194,085	12.92 %	\$ 120,136	8.00 %	\$ 150,170	10.00 %
Bank	\$ 173,042	11.74 %	\$ 117,874	8.00 %	\$ 147,342	10.00 %

Regulatory Capital as of December 31, 2011						
(Dollars in thousands)	Actual Regulatory Capital		Minimum Requirement		Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Leverage capital (Tier 1) as percent of						
three-month average assets:						
Company	\$ 167,136	9.90 %	\$ 67,525	4.00 %	\$ 84,406	5.00 %
Bank	\$ 147,617	8.75 %	\$ 67,471	4.00 %	\$ 84,339	5.00 %
As percent of risk-weighted, period-end assets						
Core capital (Tier 1)						
Company	\$ 167,136	12.42 %	\$ 53,850	4.00 %	\$ 80,774	6.00 %
Bank	\$ 147,617	11.20 %	\$ 52,700	4.00 %	\$ 79,049	6.00 %
Total capital (Tiers 1 and 2)						
Company	\$ 183,257	13.61 %	\$ 107,699	8.00 %	\$ 134,624	10.00 %
Bank	\$ 163,738	12.43 %	\$ 105,399	8.00 %	\$ 131,749	10.00 %

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(18) Segment Information

As of December 31, 2012, the Company is organized into four reportable segments: the Company and its banking and Florida trust subsidiaries (Bank), CNB Mortgage Company (CNBM), Genesee Valley Trust Company (GVT), and WBI OBS and subsidiaries (OBS). These have been segmented due to differences in their distribution channels, the volatility of their earnings, and internal and external financial reporting requirements.

The Bank segment provides a wide range of credit products and banking services to retail and commercial customers, largely within the markets the Company serves. Among the services provided by this segment are commercial and consumer lending, including residential mortgage loans, loan servicing, deposit products, cash management services, investment management and retirement services, securities custodial services, and other related products and services. These products and services are offered through several delivery channels which include traditional community banking offices, automated teller machines, telephone banking, and internet banking. CNB Mortgage originates residential mortgage loans for consumers and sells all of those loans either to the Bank or to third-party investors in the secondary market. Genesee Valley Trust Company provides investment management and retirement services. OBS provides brokerage and investment sub-advisory services to the Bank and several other financial institutions, primarily community banks and credit unions.

The financial information of these segments has been compiled utilizing the accounting policies described in Note 1. Intersegment revenue, mainly servicing release premiums, is earned on the basis of similar third-party transactions. Indirect administrative expenses are allocated among segments based upon the segments' use of indirect resources. Income taxes are allocated to segments based on the Company's marginal statutory tax rate adjusted for any tax-exempt income or non-deductible expenses. The accounting policies and processes utilized in compiling segment financial information is based on U.S. generally accepted accounting principles, as most of these companies are subject to stand-alone external financial reporting. The reportable segment information as of, and for the years ended, December 31, 2012, 2011, and 2010 follows (in thousands):

The operating results for the Bank for the year ended December 31, 2011 were negatively affected by a \$2.2 million fourth quarter accrual to account for the increased liability of the stock appreciation rights plan following the rise in the Company's stock price, while the operating results for OBS were negatively affected by \$1.1 million of merger-related expenses. The operating results of GVT for the year ended December 31, 2011 were negatively affected by a \$0.3 million increase in amortization of customer intangibles.

	2012					
	Bank	CNBM	GVT	OBS	Intersegment	Total
Net interest income	\$ 65,695	7	9	(92)	(16)	65,603
Non-interest income	29,760	7,171	3,688	3,064	(8,560)	35,123
Total revenues	95,455	7,178	3,697	2,972	(8,576)	100,726
Provision for loan losses	4,300	-	-	-	-	4,300
Intangible amortization	182	-	630	692	-	1,504
Other operating expenses	59,344	2,974	3,114	3,169	(730)	67,871
Total expenses	63,826	2,974	3,744	3,861	(730)	73,675
Income (loss) before tax	31,629	4,204	(47)	(889)	(7,846)	27,051
Income tax	8,677	1,641	(19)	(243)	(1,622)	8,434
Net income (loss) attributable to noncontrolling interest and Canandaigua National Corporation	22,952	2,563	(28)	(646)	(6,224)	18,617
Less: Net loss attributable to noncontrolling interests	6	-	-	(226)	-	(220)
Net income (loss) attributable to Canandaigua National Corporation	<u>\$ 22,946</u>	<u>2,563</u>	<u>(28)</u>	<u>(420)</u>	<u>(6,224)</u>	<u>18,837</u>
Total identifiable assets	<u>\$ 1,863,603</u>	<u>11,711</u>	<u>16,352</u>	<u>10,464</u>	<u>(15,102)</u>	<u>1,887,028</u>

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2011						
	<u>Bank</u>	<u>CNBM</u>	<u>GVT</u>	<u>OBS</u>	<u>Intersegment</u>	<u>Total</u>
Net interest income	\$ 61,473	7	11	-	(18)	61,473
Non-interest income	<u>24,510</u>	<u>3,890</u>	<u>3,863</u>	<u>187</u>	<u>(3,642)</u>	<u>28,808</u>
Total revenues	<u>85,983</u>	<u>3,897</u>	<u>3,874</u>	<u>187</u>	<u>(3,660)</u>	<u>90,281</u>
Provision for loan losses	3,775	-	-	-	-	3,775
Intangible amortization	250	-	937	-	-	1,187
Other operating expenses	<u>57,336</u>	<u>2,272</u>	<u>3,078</u>	<u>1,309</u>	<u>(779)</u>	<u>63,216</u>
Total expenses	<u>61,361</u>	<u>2,272</u>	<u>4,015</u>	<u>1,309</u>	<u>(779)</u>	<u>68,178</u>
Income (loss) before tax	24,622	1,625	(141)	(1,122)	(2,881)	22,103
Income tax	<u>6,178</u>	<u>651</u>	<u>(69)</u>	<u>-</u>	<u>(582)</u>	<u>6,178</u>
Net income (loss) attributable to noncontrolling interest and Canandaigua National Corporation	\$ 18,444	974	(72)	(1,122)	(2,299)	15,925
Less: Net loss attributable to noncontrolling interests	<u>6</u>	<u>-</u>	<u>-</u>	<u>(393)</u>	<u>-</u>	<u>(387)</u>
Net income (loss) attributable to Canandaigua National Corporation	<u>18,438</u>	<u>974</u>	<u>(72)</u>	<u>(729)</u>	<u>(2,299)</u>	<u>16,312</u>
Total identifiable assets	\$ <u>1,738,994</u>	<u>10,180</u>	<u>14,450</u>	<u>14,919</u>	<u>(17,779)</u>	<u>1,760,764</u>
2010						
	<u>Bank</u>	<u>CNBM</u>	<u>GVT</u>	<u>Intersegment</u>	<u>Total</u>	
Net interest income	\$ 61,161	12	(8)	(24)	61,141	
Non-interest income	<u>22,553</u>	<u>4,187</u>	<u>3,873</u>	<u>(3,892)</u>	<u>26,721</u>	
Total revenues	<u>83,714</u>	<u>4,199</u>	<u>3,865</u>	<u>(3,916)</u>	<u>87,862</u>	
Provision for loan losses	6,150	-	-	-	6,150	
Intangible amortization	217	-	778	-	995	
Other operating expenses	<u>51,860</u>	<u>2,122</u>	<u>3,471</u>	<u>(597)</u>	<u>56,856</u>	
Total expenses	<u>58,227</u>	<u>2,122</u>	<u>4,249</u>	<u>(597)</u>	<u>64,001</u>	
Income (loss) before tax	25,487	2,077	(384)	(3,319)	23,861	
Income tax	<u>6,205</u>	<u>775</u>	<u>62</u>	<u>(837)</u>	<u>6,205</u>	
Net income (loss)	\$ <u>19,282</u>	<u>1,302</u>	<u>(446)</u>	<u>(2,482)</u>	<u>17,656</u>	
Total identifiable assets	\$ <u>1,646,733</u>	<u>13,537</u>	<u>16,786</u>	<u>(15,552)</u>	<u>1,661,504</u>	

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(19) Condensed Financial Information - Parent Company Only

The following are the condensed balance sheets, statements of income, and statements of cash flows for Canandaigua National Corporation (in thousands).

Balance Sheets

	December 31,	
	2012	2011
Assets:		
Cash in subsidiary bank	\$ 5,815	6,825
Cash in other banks	6,311	4,430
Securities available for sale	1,145	946
Investment in Bank	157,512	150,301
Investment in nonbank subsidiaries	26,054	27,993
Other assets	5,709	6,984
Total assets	\$ 202,546	197,479
Liabilities:		
Junior subordinated debentures	\$ 51,547	51,547
Other liabilities	6,636	10,694
Total liabilities	58,183	62,241
Equity	144,363	135,238
Total liabilities and stockholders' equity	\$ 202,546	197,479

Statements of Income

	Years ended December 31,		
	2012	2011	2010
Dividends from Bank	\$ 15,600	12,960	7,200
Other income	79	64	56
Loss on securities available for sale	-	(34)	(40)
Interest and other expenses	(2,461)	(2,722)	(3,105)
Income before undistributed income of subsidiaries	13,218	10,268	4,111
Undistributed current year income of subsidiaries	6,012	6,001	13,540
Income before taxes	19,230	16,269	17,651
Income tax (expense) benefit	(393)	43	5
Net income	\$ 18,837	16,312	17,656

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Statements of Cash Flow

	<u>Years ended December 31,</u>		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
Cash flows from operating activities			
Net income	\$ 18,837	16,312	17,656
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation, amortization and accretion	-	-	24
Undistributed current year earnings of subsidiaries	(6,012)	(6,001)	(13,540)
Loss on securities available for sale	-	34	40
Other	(1,224)	(2,935)	1,432
Net cash provided by operating activities	<u>11,601</u>	<u>7,410</u>	<u>5,612</u>
Cash flows from investing activities:			
Proceeds from transactions of securities available for sale	-	62	1,499
Payment for acquisition of WBI net of cash acquired	(2,500)	(2,250)	-
Investment in subsidiaries	-	(5)	(501)
Purchases of other investments, net	-	-	(331)
Fixed assets sold to subsidiary	-	-	453
Net cash (used in) provided by investing activities	<u>(2,500)</u>	<u>(2,193)</u>	<u>1,120</u>
Cash flows from financing activities:			
Payments for treasury stock transactions, net	(151)	(173)	(147)
Tax benefit from stock option exercise	1,122	-	232
Change in noncontrolling interest, net	(226)	2,364	-
Dividends paid	(8,975)	(5,405)	(5,121)
Net cash used in financing activities	<u>(8,230)</u>	<u>(3,214)</u>	<u>(5,036)</u>
Net increase in cash	871	2,003	1,696
Cash at beginning of year	<u>11,255</u>	<u>9,252</u>	<u>7,556</u>
Cash at end of year	<u>\$ 12,126</u>	<u>11,255</u>	<u>9,252</u>

(20) Fair Values of Financial Instruments

Current accounting pronouncements require disclosure of the estimated fair value of financial instruments. Fair value is generally defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly, non-distressed sale between market participants at the measurement date. With the exception of certain marketable securities and one-to-four-family residential mortgage loans originated for sale, the Company's financial instruments are not readily marketable and market prices do not exist. The Company, in attempting to comply with accounting disclosure pronouncements, has not attempted to market its financial instruments to potential buyers, if any exist. Since negotiated prices in illiquid markets depend upon the then present motivations of the buyer and seller, it is reasonable to assume that actual sales prices could vary widely from any estimate of fair value made without the benefit of negotiations. Additionally, changes in market interest rates can dramatically impact the value of financial instruments in a short period of time. Finally, the Company expects to retain substantially all assets and liabilities measured at fair value to their maturity or call date. Accordingly, the fair values disclosed herein are unlikely to represent the instruments' liquidation values, and do not, with the exception of securities, consider exit costs, since they cannot be reasonably estimated by management.

Accounting principles establish a three-level valuation hierarchy for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels are defined as follows.

- Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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The estimated fair values and the valuation hierarchy of the Company's financial instruments are as follows (in thousands):

	Fair Value Hierarchy	December 31, 2012		December 31, 2011	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets:					
Cash and equivalents	1	\$ 91,159	91,159	126,740	126,740
Securities, available-for-sale	1, 2, 3	\$ 102,774	102,774	114,258	114,258
Securities, held-to-maturity	2	\$ 175,850	180,015	167,225	172,517
FHLB stock and Federal Reserve Bank stock	3	\$ 2,733	2,733	2,656	2,656
Loans-net	3	\$ 1,441,455	1,505,003	1,276,426	1,308,531
Loan servicing assets	3	\$ 3,221	3,382	2,489	3,244
Financial Liabilities:					
Deposits:					
Demand, savings and money market accounts	3	\$ 1,292,510	1,292,510	1,148,406	1,148,406
Time deposits	3	\$ 370,353	372,226	398,204	393,583
Borrowings	2	\$ 4,296	4,312	-	-
Junior subordinated debentures	2	\$ 51,547	51,547	51,547	52,185
Other financial instruments:					
Interest rate swap agreements	2	\$ (6,162)	(6,162)	(4,415)	(4,415)
Letters of credit	2	\$ (192)	(192)	(233)	(233)

⁽¹⁾Includes the Company's required investments in Federal Reserve Bank stock and Federal Home Loan Bank stock.

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

Cash and Equivalents

For these short-term instruments that generally mature in 90 days or less, or carry a market rate of interest, the carrying value approximates fair value.

Securities

Fair values for securities are determined using independent pricing services and market-participating brokers, or matrix models using observable inputs. The pricing service and brokers use a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to their pricing models include recent trades, benchmark interest rates, spreads, and actual and projected cash flows. Management obtains a single market quote or price estimate for each security. None of the quotes or estimates is considered a binding quote, as management would only request a binding quote if management had the positive intent to sell the securities in the foreseeable future and management believed the price quoted represented one from a market participant with the intent and the ability to purchase. Management evaluates the supplied price quotes against expectations of general price trends associated with changes in the yield curve and by comparing prices to the last period's price quote. Management employs an internal matrix model for non-traded municipal securities. The matrix model considers observable inputs, such as benchmark interest rates and spreads.

Certain securities' fair values are determined using unobservable inputs and include bank-debt-based CDOs. There is a very limited market and limited demand for these CDOs due to imbalances in marketplace liquidity and the uncertainty in evaluating the credit risk in these securities. In determining fair value for these securities, management considered various inputs. Management considered fair values from brokerage firms which were determined using assumptions as to expected cash flows and approximate risk-adjusted discount rates.

There is no market for stock issued by the Federal Home Loan Bank or the Federal Reserve Bank. Member banks are required to hold this stock. Shares can only be sold to the issuer at par. Fair value is estimated to equal book value.

Loans

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by interest type such as floating, adjustable, and fixed-rate, and by portfolios such as commercial, mortgage, and consumer.

The fair value of performing loans is calculated by discounting scheduled cash flows through the loans' estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan category. The estimate of maturity is based on the average maturity for each loan classification.

Delinquent loans (not in foreclosure) are valued using the method noted above, and also consider the fair value of collateral for collateral-dependent loans. While credit risk is a component of the discount rate used to value loans, delinquent loans are presumed to possess additional risk. Therefore, the calculated fair value of loans is reduced by the allowance for loan losses.

The fair value of loans held for sale is estimated based on outstanding investor commitments or in the absence of such commitments, is based on current yield requirements or quoted market prices.

Loan Servicing Assets

Fair value is determined through estimates provided by a third party. To estimate the fair value, the third party considers market prices for similar assets, and the present value of expected future cash flows associated with the servicing assets calculated using assumptions that market participants would use in estimating future servicing income and expense. Such assumptions include estimates of the cost of servicing loans, loan default rates, an appropriate discount rate, and prepayment speeds. The key economic assumptions used to determine the fair value of mortgage servicing rights and the sensitivity of such values to changes in those assumptions are summarized in Note 6.

Deposits

The fair value of demand deposits, savings accounts, and money market accounts is the amount payable on demand at the reporting date. The fair value of fixed maturity time deposits is estimated using a discounted cash flow approach that applies current market rates to a schedule of aggregated expected maturities of time deposits.

Borrowings

The fair value of borrowings is based on quoted market prices for the identical debt when traded as an asset in an active market. If a quoted market price is not available, fair value is calculated by discounting scheduled cash flows through the borrowings' estimated maturity using current market rates.

Junior Subordinated Debentures

There is no active trading market for the Company's debentures. Therefore the fair value of junior subordinated debentures is determined using an expected present value technique. The fair value of adjustable-rate debentures approximates their face amount, while the fair value of fixed-rate debentures is calculated by discounting scheduled cash flows through the debenture's estimated maturity using current market rates.

Interest Rate Swap Agreements (Swaps)

The fair value of swaps is the amount the Company would expect to pay to terminate the agreements and is based upon the present value of expected future cash flows using the LIBOR swap curve, the basis for the underlying interest rates.

Other Financial Instruments

The fair values of letters of credit and unused lines of credit approximate the fee charged to make the commitments.

CANANDAIGUA NATIONAL CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements December 31, 2012, 2011, 2010

(21) Fair Values Measurements

The following table presents for each of the fair-value hierarchy levels discussed in Note 20 the Company's assets and liabilities that are measured at fair value on a recurring and non-recurring basis at December 31, 2012, by caption on the Consolidated Balance Sheet (dollars in thousands).

	Quoted market prices in active markets (Level 1)	Internal models with significant observable market parameters (Level 2)	Internal models with significant unobservable market parameters (Level 3)	Total carrying value in the Consolidated Balance Sheet
Measured on a recurring basis:				
Assets				
Securities available-for-sale:				
U.S. Treasury	\$ 500	-	-	500
U.S. government sponsored enterprise obligations	-	60,176	-	60,176
State and municipal obligation	-	38,686	-	38,686
All other	-	3,292	120	3,412
Total assets	<u>\$ 500</u>	<u>102,154</u>	<u>120</u>	<u>102,774</u>
Liabilities				
Interest rate swap agreement	\$ -	6,162	-	6,162
Letters of credit	-	192	-	192
Total liabilities	<u>\$ -</u>	<u>6,354</u>	<u>-</u>	<u>6,354</u>
Measured on a non-recurring basis:				
Assets				
Loans				
Loans-held-for-sale	\$ -	21,113	-	21,113
Collateral dependent impaired loans	-	-	1,200	1,200
Other assets				
Other real estate owned	-	-	3,556	3,556
Loan servicing assets	-	-	3,221	3,221
Total assets	<u>\$ -</u>	<u>21,113</u>	<u>7,977</u>	<u>29,090</u>

The Company values impaired loans and other real estate owned at the time the loan is identified as impaired or when title to the property passes to the Company. The fair values of such loans and real estate owned are estimated using Level 3 inputs in the fair value hierarchy. Each loan's collateral and real estate property has a unique appraisal and management's consideration of any discount of the value is based on factors unique to each impaired loan and real estate property. The significant unobservable input in determining the fair value is management's subjective discount on appraisals of the collateral securing the loan or real estate property, which ranges from 10%-50%. Collateral for impaired loans may consist of real estate and/or business assets including equipment, inventory and/or accounts receivable and the value of these assets is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, estimated costs to sell, and/or management's expertise and knowledge of the client and the client's business.

As more fully described in the prior note, the Company evaluates and values loan servicing assets on a quarterly basis at their lower of amortized cost or fair value. The fair values of these assets are estimated using Level 3 inputs in the fair value hierarchy. Fair value is determined through estimates provided by a third party or by management by reference to rights sold on similar loans during the quarter. When values are estimated by management using market prices for similar servicing assets, certain discounts may be applied to reflect the differing rights underlying the loan servicing contract. These discounts may range from 25 to 75 basis points of the principal balance of the underlying loan. Such discounts represent the significant unobservable input.

CANANDAIGUA NATIONAL CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements December 31, 2012, 2011, 2010

The following table shows a reconciliation of the beginning and ending balances for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the December 31, 2012 (in thousands). During the first quarter of 2012 certain securities were transferred to Level 2 classification. These securities show an active trading market, which resulted in fair values with significant observable elements.

Securities available for sale, beginning of period	\$	799
Securities transferred to Level 2 during period		(704)
Unrealized gain included in other comprehensive income		<u>25</u>
Securities available for sale, end of period	\$	<u><u>120</u></u>

The following table presents for each of the fair-value hierarchy levels discussed in Note 20 the Company's assets and liabilities that are measured at fair value on a recurring and non-recurring basis at December 31, 2011, by caption on the Consolidated Balance Sheet (dollars in thousands).

	<u>Quoted market prices in active markets (Level 1)</u>	<u>Internal models with significant observable market parameters (Level 2)</u>	<u>Internal models with significant unobservable market parameters (Level 3)</u>	<u>Total carrying value in the Consolidated Balance Sheet</u>
Measured on a recurring basis:				
Assets				
Securities available-for-sale:				
U.S. Treasury	\$ 502	-	-	502
U.S. government sponsored enterprise obligations	-	56,125	-	56,125
State and municipal obligation	-	55,425	-	55,425
All other	-	1,407	799	2,206
Total assets	<u>\$ 502</u>	<u>112,957</u>	<u>799</u>	<u>114,258</u>
Liabilities				
Interest rate swap agreement	\$ -	4,415	-	4,415
Letters of credit	-	233	-	233
Total liabilities	<u>\$ -</u>	<u>4,648</u>	<u>-</u>	<u>4,648</u>
Measured on a non-recurring basis:				
Assets				
Loans				
Loans-held-for-sale	\$ -	7,556	-	7,556
Collateral dependent impaired loans	-	-	2,453	2,453
Other assets				
Other real estate owned	-	-	4,235	4,235
Loan servicing assets	-	-	2,489	2,489
Total assets	<u>\$ -</u>	<u>7,556</u>	<u>9,177</u>	<u>16,733</u>

The following table shows a reconciliation of the beginning and ending balances for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the December 31, 2011 (in thousands).

Securities available for sale, beginning of period	\$	958
Realized loss included in operations		(34)
Unrealized loss included in other comprehensive income		<u>(125)</u>
Securities available for sale, end of period	\$	<u><u>799</u></u>

Board of Directors

Canandaigua National Corporation is honored to have so many distinguished community leaders on its Board of Directors.



*Board of Directors:
(front row) Frank H. Hamlin, III, Caroline C. Shipley, George W. Hamlin, IV, Sue S. Stewart, Stephen D. Hamlin. (back row) Richard P. Miller Jr., Alan J. Stone, Richard C. Fox, Robert G. Sheridan, Daniel P. Fuller.*

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President, Wendy's Restaurants of Rochester, Inc., 1976-present
Chairman of the Board, Genesee Valley Trust Company,* 2011-present
Director, Genesee Valley Trust Company,* 1998-2011
Trustee, Genesee Country Village and Museum

Daniel P. Fuller

Vice-Chair of the Board, Canandaigua National Corporation, January 1, 2011-present
Chairman of the Board, Canandaigua National Corporation, 2008-2010
President and General Manager, Bristol Mountain Ski Resort, December 1984-present
General Manager, Roseland Waterpark, 2003-present

Frank H. Hamlin, III, Esq.

President, Canandaigua National Corporation, January 1, 2011-present
President, The Canandaigua National Bank and Trust Company, January 1, 2011-present
Director, Canandaigua National Trust Company of Florida,* 2011-present
Director and President, CNB Operating Subsidiary No. 1 Inc., d/b/a CNB Insurance Agency,* 2011-present
Director, Genesee Valley Trust Company,* 2011-present
Director, Officer, Home Town Funding, Inc. d/b/a CNB Mortgage Company,** 2011-present
CEO, WBI OBS Financial, LLC,* 2011-present
Of Counsel, Croucher, Jones & Johns, 2007-2010
Attorney, June 2001-2007

George W. Hamlin, IV

Chairman of the Board and CEO, Canandaigua National Corporation, January 1, 2011-present
Chairman, CEO, and Trust Officer, The Canandaigua National Bank and Trust Company, 1979-present
President, CEO, and Trust Officer, The Canandaigua National Bank and Trust Company, 1979-2010
Chairman, CEO, and Trust Officer, The Canandaigua National Trust Company of Florida,* 2009-present
Director and CEO, CNB Operating Subsidiary No. 1 Inc. d/b/a CNB Insurance Agency,* 1995-present
Director, Genesee Valley Trust Company,* 2008-present
Chairman, CEO, Home Town Funding, Inc., d/b/a CNB Mortgage Company,** 1998-present
Director, Federal Reserve Bank of New York, 1997-2002
Chair Emeritus, Thompson Health System
Chair, Eastman School of Music
Director, University of Rochester Medical Center, Vice Chair 2011-2012
Director, Center for Governmental Research, 2002-2010
Chair, Investment Committee-Monroe Fund
Director, New York Wine and Culinary Center
Director, CMAC (Constellation Brands—Marvin Sands Performing Arts Center)

Stephen D. Hamlin

Retired Cultural Leader
Chief Executive Officer, Sonnenberg Gardens, February 1996-2000
Vice President, Schlegel Corp., 1963-1984

Richard P. Miller Jr.

Mayor, City of Oneonta, NY
President, Hartwick College, 2003-2008
Vice Chancellor and Chief Operating Officer, State University of New York, 2000-2003
Senior Vice President and Chief Operating Officer, University of Rochester, 1996-2000

Robert G. Sheridan

Retired, The Canandaigua National Bank and Trust Company, 1971-2011
Cashier, 1989-December 31, 2011
Executive Vice President, CRA Officer, 2007-August 31, 2011
Senior Vice President, 1989-2006
Secretary, Canandaigua National Corporation, 1992-August 31, 2011
Retired, President, CNB Mortgage Company** 2002-August 31, 2011
Director, Home Town Funding Inc., d/b/a CNB Mortgage Company,** 1998-present
Director, Genesee Valley Trust Company,* 2008-December 31, 2011
Former Chair, United Way of Ontario County

Caroline C. Shipley

Retired
Treasurer, First Congregational Church
Treasurer, Ontario Children's Foundation
Member, Canandaigua City School District Board of Education, 1979-2009
President, 1983-1991, 2007-2009
Financial Manager, Dell Broadcasting WCGRWLKA, 1985-1991
Treasurer and Financial Manager, Sonnenberg Gardens, 1973-1984

Sue S. Stewart

Retired, Senior Vice President and General Counsel, University of Rochester, 2003-2012
Partner, Nixon Peabody LLP, 1978-2001
Managing Partner, Rochester Office, 1998-2000
Former Director, United Way of Greater Rochester
Co-chair, Board of Trustees, National Center for Education and the Economy

Alan J. Stone

Managing Member, Stone Family Properties LLC, 1986-present
Member, City Mini Storage LLC, 1999-present
Director, Stone Construction Equipment, Inc., 1969-2009
Chairman of the Board, Canandaigua National Corporation, 1994-2004
Co-founder and CEO, Stone Construction Equipment, Inc., 1969-1986

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Steven H. Swartout, Esq. *Executive Vice President and Secretary*
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* Wholly owned subsidiary of Canandaigua National Corporation

** Wholly owned subsidiary of The Canandaigua National Bank and Trust Company

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Kim Brewer, Community Office Assistant Manager

Brighton

Amy Flaitz, Community Office Assistant Manager

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Holly Carroll, Community Office Assistant Manager
Garrett Hafler, Community Office Assistant Manager

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Iva Doser, Community Office Assistant Manager

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Rayon Boxx, Community Office Assistant Manager

Perinton

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Rochester

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Victor

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Webster BayTowne

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Patricia N. Vitale, Community Office Assistant Manager

Webster Jackson Ridge

James D. Schrader, Assistant Vice President – Community Office Manager
Jerry Lack, Community Office Assistant Manager

Canandaigua National Corporation

Canandaigua National Trust Company of Florida

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Paul S. Tarantino, Vice President – Business Development Officer
Noleen R. Burch, Vice President
Lynn M. Carleton, Vice President – Trust Administration Officer
Donna L. Cator, CFP®, Vice President – Financial Planning Officer
James F. Lieb, Senior Vice President – Group Manager, Trust Administration Services
Lawrence A. Heilbronner, Executive Vice President and CFO
Steven H. Swartout, Esq., Executive Vice President and Trust Officer
Daniel R. Goodwin, Director
Frank H. Hamlin, III, Esq., Director
Garth C. Harding, Director
Alan M. Lupton, Director
Richard C. McCarthy, Director
Stephen Natapow, Director
Bernice W. Skirboll, Director
Albert W. White, Director Emeritus

CNB Insurance Agency

George W. Hamlin, IV, CEO and Director
Frank H. Hamlin, III, Esq., President and Director
Lawrence A. Heilbronner, Executive Vice President
Gregory S. MacKay, Treasurer
Margaret W. Meyer, Insurance Officer
Michael Schiller, Insurance Officer

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Joseph L. Dugan, CEO, President, and Director
Joy Ryan Plotnik, Esq., Senior Vice President – Trust Officer and Chief Operating Officer
Geoffrey E. Blyth, Vice President – Investment Officer
Robert Carville, Vice President – Business Development Officer
Kurt E. Rosen, Operations Manager
Frank H. Hamlin, III, Esq., Director
George W. Hamlin, IV, Director
Karen Noble Hanson, Director
Lawrence A. Heilbronner, Director
Thomas Hildebrandt, Director
James D. Ryan, Director
Steven H. Swartout, Esq., Director

Home Town Funding, Inc. d/b/a CNB Mortgage Company

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Christopher R. Spaker, President
Helen M. Saxby, Vice President – Operations Manager
Frank H. Hamlin, III, Esq., Managing Director
Lawrence A. Heilbronner, Director and Treasurer
Karen C. Serinis, Managing Director
Robert G. Sheridan, Director and Secretary

WBI OBS Financial, LLC

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Jason C. Farmer, Manager
Lawrence A. Heilbronner, Manager
Aaron M. Reitz, Manager
Steven H. Swartout, Esq., Manager

OBS Holdings, Inc.

Christopher S. Campbell, Chairman
John Henry, President and CEO
Catherine Farley, Chief Operating Officer
Barbara Mulhern, Chief Marketing Officer

THE ARTHUR S. HAMLIN AWARD FOR EXCELLENCE

Every year, the Bank recognizes the outstanding contribution of one of its own with the Arthur S. Hamlin Award. Employees are encouraged to nominate one of their peers who has demonstrated exceptional performance and dedication to the Bank. Congratulations to this year's recipients, Brendon Crossing and Darlene Rogers.



*It was a great honor to be a recipient of the **Arthur S. Hamlin Award for Excellence**. Mr. Hamlin was an upstanding member of our community and a great leader of our bank. It is humbling to receive an award named after him. I have had the pleasure of working for Canandaigua National Bank & Trust for the past 15 years. Throughout that time, it's been clear to me that CNB is an organization that truly cares about its employees and the communities we serve. This award is another example.*

Brendon Crossing, 2011 Arthur S. Hamlin Award Recipient



*It was an honor to be awarded the **Arthur S. Hamlin Award for Excellence**. It is the employees of Canandaigua National Bank & Trust who make it a great place to work. To be recognized and nominated by co-workers is special.*

Darlene Rogers, 2011 Arthur S. Hamlin Award Recipient

2 0 1 2 N O M I N E E S

Kathleen C. Amberge
Bernard E. Belcher
H. Christine Bond

Lawrence P. Gamba
Michelle M. Klehr
Rebecca A. Long

Michael O'Donnell
Diana S. Wright

P A S T R E C I P I E N T S

Lori R. Ellis 2010
Kathleen A. Housel 2009
Chris Keys 2008
Barbara Finch 2007
Jim Terwilliger 2006
Brenda Whitney 2006
Vicki Mandrino 2005
Michael Mandrino 2004
Tamra O'Donnell 2004

Lisa Blakesley 2003
Jason Ingalls 2002
Brenda Stoker 2001
Lena Hayes 2000
Dawn Phelps 1999
Beth Uhlen 1998
Kathy Lafler 1997
Jeannie Blance 1996
Amy Eagley 1995

Regina Kesel 1995
Susan Foose 1994
Kathleen Corry 1993
James Roth 1992
Michael O'Donnell 1991
Jerry Drake 1990
Linda Keyes 1989

Notes



George W. Hamlin, Elizabeth Bagley, and Henry A. Beeman—1916.

“We understand that the purpose of this wonderful enterprise is its sustainability, fiduciary duty, and good stewardship with respect to not just one of our constituents, but all four.”

George W. Hamlin, IV

—George W. Hamlin, IV
Chairman and CEO

“We continue to attract talent with a customer-centric mentality, and will continue to support their efforts—through creativity and ingenuity—to provide the valuable customer experience to which our clients have become accustomed.”

Frank H. Hamlin, III

—Frank H. Hamlin, III
President



Canandaigua
National
Corporation

