

CNB FINANCIAL CORP/PA

Form 10-Q

November 08, 2012

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10 - Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2012

or

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

For the transition period from            to

Commission File Number 000-13396

**CNB FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

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**Pennsylvania**  
(State or other jurisdiction of  
incorporation or organization)

**25-1450605**  
(I.R.S. Employer  
Identification No.)

**1 South Second Street**

**P.O. Box 42**

**Clearfield, Pennsylvania 16830**

(Address of principal executive offices)

**Registrant's telephone number, including area code, (814) 765-9621**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☒ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

|                         |                          |                           |                                     |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer         | <input checked="" type="checkbox"/> |
| Non-accelerated filer   | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/>            |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

The number of shares outstanding of the issuer's common stock as of November 5, 2012

COMMON STOCK NO PAR VALUE PER SHARE: 12,474,024 SHARES

**Table of Contents**

INDEX

**PART I.**

**FINANCIAL INFORMATION**

|                                                                                                                | Page Number |
|----------------------------------------------------------------------------------------------------------------|-------------|
| <u>ITEM 1 Financial Statements (unaudited)</u>                                                                 |             |
| <u>Consolidated Balance Sheets September 30, 2012 and December 31, 2011</u>                                    | 1           |
| <u>Consolidated Statements of Income Three months ended September 30, 2012 and 2011</u>                        | 2           |
| <u>Consolidated Statements of Income Nine months ended September 30, 2012 and 2011</u>                         | 3           |
| <u>Consolidated Statements of Comprehensive Income Three and nine months ended September 30, 2012 and 2011</u> | 4           |
| <u>Consolidated Statements of Cash Flows Nine months ended September 30, 2012 and 2011</u>                     | 5           |
| <u>Notes to Consolidated Financial Statements</u>                                                              | 6           |
| <u>ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>            | 29          |
| <u>ITEM 3 Quantitative and Qualitative Disclosures about Market Risk</u>                                       | 38          |
| <u>ITEM 4 Controls and Procedures</u>                                                                          | 39          |

**PART II.**

**OTHER INFORMATION**

|                                 |    |
|---------------------------------|----|
| <u>ITEM 1 Legal Proceedings</u> | 40 |
| <u>ITEM 1A Risk Factors</u>     | 40 |
| <u>ITEM 6 Exhibits</u>          | 40 |
| <u>Signatures</u>               | 41 |

## **Table of Contents**

### **Forward-Looking Statements**

This document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, with respect to our financial condition, liquidity, results of operations, future performance and business. These forward-looking statements are intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are those that are not historical facts. Forward-looking statements include statements with respect to beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions that are subject to significant risks and uncertainties and are subject to change based on various factors (some of which are beyond our control). Forward-looking statements often include words such as believes, expects, anticipates, estimates, intends, plans or similar expressions or future conditional verbs such as may, will, should, would and could. Such known and unknown risks, uncertainties and other factors that could cause the actual results to differ materially from the statements include, but are not limited to: changes in general business, industry or economic conditions or competition; changes in any applicable law, rule, regulation, policy, guideline or practice governing or affecting financial holding companies and their subsidiaries or with respect to tax or accounting principles or otherwise; adverse changes or conditions in capital and financial markets; changes in interest rates; higher than expected costs or other difficulties related to integration of combined or merged businesses; the inability to realize expected cost savings or achieve other anticipated benefits in connection with business combinations and other acquisitions; changes in the quality or composition of our loan and investment portfolios; adequacy of loan loss reserves; increased competition; loss of certain key officers; continued relationships with major customers; deposit attrition; rapidly changing technology; unanticipated regulatory or judicial proceedings and liabilities and other costs; changes in the cost of funds, demand for loan products or demand for financial services; and other economic, competitive, governmental or technological factors affecting our operations, markets, products, services and prices. Some of these and other factors are discussed in our annual and quarterly reports filed with the Securities and Exchange Commission. Such factors could cause actual results to differ materially from those in the forward-looking statements.

The forward-looking statements are based upon management's beliefs and assumptions and are made as of the date of the filing of this document. We undertake no obligation to publicly update or revise any forward-looking statements included in this document or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise, except to the extent required by law. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this document might not occur and you should not put undue reliance on any forward-looking statements.

**Table of Contents**

## Part I Financial Information

## Item 1. Financial Statements

## CONSOLIDATED BALANCE SHEETS

Dollars in thousands, except share data

|                                                                                                        | (unaudited)<br>September 30,<br>2012 | December 31,<br>2011 |
|--------------------------------------------------------------------------------------------------------|--------------------------------------|----------------------|
| <b><u>ASSETS</u></b>                                                                                   |                                      |                      |
| Cash and due from banks                                                                                | \$ 29,121                            | \$ 36,032            |
| Interest bearing deposits with other banks                                                             | 3,825                                | 3,671                |
| Total cash and cash equivalents                                                                        | 32,946                               | 39,703               |
| Interest bearing time deposits with other banks                                                        | 225                                  | 224                  |
| Securities available for sale                                                                          | 719,284                              | 638,107              |
| Trading securities                                                                                     | 3,620                                | 3,233                |
| Loans held for sale                                                                                    | 3,847                                | 1,442                |
| Loans                                                                                                  | 913,614                              | 852,769              |
| Less: unearned discount                                                                                | (3,397)                              | (2,886)              |
| Less: allowance for loan losses                                                                        | (13,649)                             | (12,615)             |
| Net loans                                                                                              | 896,568                              | 837,268              |
| FHLB and other equity interests                                                                        | 6,755                                | 6,537                |
| Premises and equipment, net                                                                            | 24,342                               | 24,004               |
| Bank owned life insurance                                                                              | 27,424                               | 25,672               |
| Mortgage servicing rights                                                                              | 782                                  | 906                  |
| Goodwill                                                                                               | 10,946                               | 10,821               |
| Accrued interest receivable and other assets                                                           | 14,458                               | 14,290               |
| <b>TOTAL</b>                                                                                           | <b>\$ 1,741,197</b>                  | <b>\$ 1,602,207</b>  |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>                                                     |                                      |                      |
| Non-interest bearing deposits                                                                          | \$ 168,888                           | \$ 152,732           |
| Interest bearing deposits                                                                              | 1,311,382                            | 1,201,119            |
| Total deposits                                                                                         | 1,480,270                            | 1,353,851            |
| FHLB and other borrowings                                                                              | 74,336                               | 74,456               |
| Subordinated debentures                                                                                | 20,620                               | 20,620               |
| Accrued interest payable and other liabilities                                                         | 22,280                               | 21,391               |
| Total liabilities                                                                                      | 1,597,506                            | 1,470,318            |
| Common stock, \$0 par value; authorized 50,000,000 shares; issued 12,599,603 shares                    | 0                                    | 0                    |
| Additional paid in capital                                                                             | 44,150                               | 44,350               |
| Retained earnings                                                                                      | 87,128                               | 80,038               |
| Treasury stock, at cost (129,232 shares at September 30, 2012 and 222,285 shares at December 31, 2011) | (1,828)                              | (3,260)              |
| Accumulated other comprehensive income                                                                 | 14,241                               | 10,761               |

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|                            |              |              |
|----------------------------|--------------|--------------|
| Total shareholders' equity | 143,691      | 131,889      |
| TOTAL                      | \$ 1,741,197 | \$ 1,602,207 |

See Notes to Consolidated Financial Statements

**Table of Contents**

## CONSOLIDATED STATEMENTS OF INCOME (unaudited)

Dollars in thousands, except per share data

|                                                                                                  | Three months ended<br>September 30, |           |
|--------------------------------------------------------------------------------------------------|-------------------------------------|-----------|
|                                                                                                  | 2012                                | 2011      |
| <b>INTEREST AND DIVIDEND INCOME:</b>                                                             |                                     |           |
| Loans including fees                                                                             | \$ 12,574                           | \$ 12,344 |
| Deposits with banks                                                                              | 0                                   | 20        |
| Securities:                                                                                      |                                     |           |
| Taxable                                                                                          | 3,651                               | 3,689     |
| Tax-exempt                                                                                       | 892                                 | 732       |
| Dividends                                                                                        | 16                                  | 8         |
| Total interest and dividend income                                                               | 17,133                              | 16,793    |
| <b>INTEREST EXPENSE:</b>                                                                         |                                     |           |
| Deposits                                                                                         | 2,424                               | 3,424     |
| Borrowed funds                                                                                   | 834                                 | 796       |
| Subordinated debentures                                                                          | 205                                 | 195       |
| Total interest expense                                                                           | 3,463                               | 4,415     |
| NET INTEREST INCOME                                                                              | 13,670                              | 12,378    |
| PROVISION FOR LOAN LOSSES                                                                        | 1,188                               | 904       |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES                                              | 12,482                              | 11,474    |
| <b>NON-INTEREST INCOME:</b>                                                                      |                                     |           |
| Wealth and asset management fees                                                                 | 498                                 | 415       |
| Service charges on deposit accounts                                                              | 1,049                               | 1,097     |
| Other service charges and fees                                                                   | 467                                 | 433       |
| Net realized and unrealized gains (losses) on securities for which fair value was elected        | 275                                 | (313)     |
| Mortgage banking                                                                                 | 225                                 | 172       |
| Bank owned life insurance                                                                        | 229                                 | 213       |
| Other                                                                                            | 233                                 | 361       |
|                                                                                                  | 2,976                               | 2,378     |
| Total other-than-temporary impairment losses on available-for-sale securities                    | 0                                   | 0         |
| Less portion of loss recognized in other comprehensive income                                    | 0                                   | 0         |
| Net impairment losses recognized in earnings                                                     | 0                                   | 0         |
| Net realized gains on available-for-sale securities                                              | 103                                 | 84        |
| Net impairment losses recognized in earnings and realized gains on available-for-sale securities | 103                                 | 84        |
| Total non-interest income                                                                        | 3,079                               | 2,462     |
| <b>NON-INTEREST EXPENSES:</b>                                                                    |                                     |           |

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|                                   |          |          |
|-----------------------------------|----------|----------|
| Salaries and benefits             | 4,831    | 4,402    |
| Net occupancy expense of premises | 1,138    | 1,076    |
| FDIC insurance premiums           | 283      | 240      |
| Other                             | 2,956    | 2,592    |
| Total non-interest expenses       | 9,208    | 8,310    |
| INCOME BEFORE INCOME TAXES        | 6,353    | 5,626    |
| INCOME TAX EXPENSE                | 1,790    | 1,559    |
| NET INCOME                        | \$ 4,563 | \$ 4,067 |
| EARNINGS PER SHARE:               |          |          |
| Basic                             | \$ 0.37  | \$ 0.33  |
| Diluted                           | \$ 0.37  | \$ 0.33  |
| DIVIDENDS PER SHARE:              |          |          |
| Cash dividends per share          | \$ 0.165 | \$ 0.165 |

See Notes to Consolidated Financial Statements



**Table of Contents**

## CONSOLIDATED STATEMENTS OF INCOME (unaudited)

Dollars in thousands, except per share data

|                                                                                                      | Nine months ended<br>September 30, |            |
|------------------------------------------------------------------------------------------------------|------------------------------------|------------|
|                                                                                                      | 2012                               | 2011       |
| <b>INTEREST AND DIVIDEND INCOME:</b>                                                                 |                                    |            |
| Loans including fees                                                                                 | \$ 37,223                          | \$ 36,011  |
| Deposits with banks                                                                                  | 0                                  | 102        |
| Securities:                                                                                          |                                    |            |
| Taxable                                                                                              | 11,226                             | 10,640     |
| Tax-exempt                                                                                           | 2,668                              | 2,128      |
| Dividends                                                                                            | 47                                 | 23         |
| <br>Total interest and dividend income                                                               | <br>51,164                         | <br>48,904 |
| <b>INTEREST EXPENSE:</b>                                                                             |                                    |            |
| Deposits                                                                                             | 8,519                              | 10,360     |
| Borrowed funds                                                                                       | 2,418                              | 2,373      |
| Subordinated debentures                                                                              | 606                                | 582        |
| <br>Total interest expense                                                                           | <br>11,543                         | <br>13,315 |
| <br>NET INTEREST INCOME                                                                              | <br>39,621                         | <br>35,589 |
| PROVISION FOR LOAN LOSSES                                                                            | 4,038                              | 2,673      |
| <br>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES                                              | <br>35,583                         | <br>32,916 |
| <b>NON-INTEREST INCOME:</b>                                                                          |                                    |            |
| Wealth and asset management fees                                                                     | 1,311                              | 1,225      |
| Service charges on deposit accounts                                                                  | 3,020                              | 3,129      |
| Other service charges and fees                                                                       | 1,367                              | 1,201      |
| Net realized and unrealized gains (losses) on securities for which fair value was elected            | 455                                | (216)      |
| Mortgage banking                                                                                     | 686                                | 506        |
| Bank owned life insurance                                                                            | 752                                | 674        |
| Other                                                                                                | 767                                | 986        |
| <br>                                                                                                 | <br>8,358                          | <br>7,505  |
| <br>Total other-than-temporary impairment losses on available-for-sale securities                    | <br>0                              | <br>(398)  |
| Less portion of loss recognized in other comprehensive income                                        | 0                                  | 0          |
| <br>Net impairment losses recognized in earnings                                                     | <br>0                              | <br>(398)  |
| Net realized gains on available-for-sale securities                                                  | 1,400                              | 158        |
| <br>Net impairment losses recognized in earnings and realized gains on available-for-sale securities | <br>1,400                          | <br>(240)  |
| <br>Total non-interest income                                                                        | <br>9,758                          | <br>7,265  |
| <b>NON-INTEREST EXPENSES:</b>                                                                        |                                    |            |

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|                                   |           |           |
|-----------------------------------|-----------|-----------|
| Salaries and benefits             | 14,175    | 12,842    |
| Net occupancy expense of premises | 3,394     | 3,378     |
| FDIC insurance premiums           | 816       | 969       |
| Other                             | 8,670     | 7,553     |
| Total non-interest expenses       | 27,055    | 24,742    |
| INCOME BEFORE INCOME TAXES        | 18,286    | 15,439    |
| INCOME TAX EXPENSE                | 5,040     | 4,204     |
| NET INCOME                        | \$ 13,246 | \$ 11,235 |
| EARNINGS PER SHARE:               |           |           |
| Basic                             | \$ 1.07   | \$ 0.91   |
| Diluted                           | \$ 1.06   | \$ 0.91   |
| DIVIDENDS PER SHARE:              |           |           |
| Cash dividends per share          | \$ 0.495  | \$ 0.495  |

See Notes to Consolidated Financial Statements

## Table of Contents

### CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

Dollars in thousands

|                                                                                                                                                                                                                                                     | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                                                                                                                                                                                                                                                     | 2012                                | 2011     | 2012                               | 2011      |
| NET INCOME                                                                                                                                                                                                                                          | \$ 4,563                            | \$ 4,067 | \$ 13,246                          | \$ 11,235 |
| Other comprehensive income, net of tax:                                                                                                                                                                                                             |                                     |          |                                    |           |
| Change in fair value of interest rate swap agreements designated as cash flow hedges, net of tax of \$24 and \$237 for the three months ended September 30, 2012 and 2011, and \$62 and \$279 for the nine months ended September 30, 2012 and 2011 | (44)                                | (440)    | (116)                              | (519)     |
| Net change in unrealized gains (losses) on securities available for sale:                                                                                                                                                                           |                                     |          |                                    |           |
| Unrealized gains (losses) on other-than-temporarily impaired securities available for sale:                                                                                                                                                         |                                     |          |                                    |           |
| Unrealized gains (losses) arising during the period, net of tax of \$49 for the three months ended September 30, 2011, and (\$7) and \$17 for the nine months ended September 30, 2012 and 2011                                                     | 0                                   | (91)     | 13                                 | (31)      |
| Reclassification adjustment for losses included in net income, net of tax of (\$139) for the nine months ended September 30, 2011                                                                                                                   | 0                                   | 0        | 0                                  | 259       |
|                                                                                                                                                                                                                                                     | 0                                   | (91)     | 13                                 | 228       |
| Unrealized gains on other securities available for sale:                                                                                                                                                                                            |                                     |          |                                    |           |
| Unrealized gains arising during the period, net of tax of (\$611) and (\$3,441) for the three months ended September 30, 2012 and 2011, and (\$2,419) and (\$7,998) for the nine months ended September 30, 2012 and 2011                           | 1,134                               | 6,391    | 4,493                              | 14,854    |
| Reclassification adjustment for accumulated gains included in net income, net of tax of \$36 and \$29 for the three months ended ended September 30, 2012 and 2011, and \$490 and \$55 for the nine months ended September 30, 2012 and 2011        | (67)                                | (55)     | (910)                              | (103)     |
|                                                                                                                                                                                                                                                     | 1,067                               | 6,336    | 3,583                              | 14,751    |
| Other comprehensive income                                                                                                                                                                                                                          | 1,023                               | 5,805    | 3,480                              | 14,460    |
| COMPREHENSIVE INCOME                                                                                                                                                                                                                                | \$ 5,586                            | \$ 9,872 | \$ 16,726                          | \$ 25,695 |

See Notes to Consolidated Financial Statements

**Table of Contents**

## CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

Dollars in thousands

|                                                                                                | Nine months ended<br>September 30, |                  |
|------------------------------------------------------------------------------------------------|------------------------------------|------------------|
|                                                                                                | 2012                               | 2011             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                                   |                                    |                  |
| Net income                                                                                     | \$ 13,246                          | \$ 11,235        |
| Adjustments to reconcile net income to net cash provided by operations:                        |                                    |                  |
| Provision for loan losses                                                                      | 4,038                              | 2,673            |
| Depreciation and amortization of premises and equipment                                        | 1,582                              | 1,539            |
| Securities amortization and accretion and deferred loan fees and costs                         | 3,353                              | 1,898            |
| Net impairment losses realized in earnings and gains on sales of available-for-sale securities | (1,400)                            | 240              |
| Net realized and unrealized (gains) losses on securities for which fair value was elected      | (455)                              | 216              |
| Proceeds from sale of securities for which fair value was elected                              | 2,625                              | 170              |
| Purchase of securities for which fair value was elected                                        | (2,699)                            | (899)            |
| Gain on sale of loans                                                                          | (640)                              | (424)            |
| Net gains on dispositions of premises and equipment and foreclosed assets                      | (120)                              | (102)            |
| Proceeds from sale of loans                                                                    | 21,674                             | 14,735           |
| Origination of loans held for sale                                                             | (23,524)                           | (11,109)         |
| Income on bank owned life insurance                                                            | (752)                              | (674)            |
| Stock-based compensation expense                                                               | 205                                | 164              |
| Contribution of treasury stock                                                                 | 90                                 | 90               |
| Changes in:                                                                                    |                                    |                  |
| Accrued interest receivable and other assets                                                   | (1,998)                            | (2,347)          |
| Accrued interest payable and other liabilities                                                 | 710                                | 4,966            |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                               | <b>15,935</b>                      | <b>22,371</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                                   |                                    |                  |
| Net (increase) decrease in interest bearing time deposits with other banks                     | (1)                                | 2,593            |
| Proceeds from maturities, prepayments and calls of securities                                  | 82,288                             | 75,791           |
| Proceeds from sales of securities                                                              | 92,707                             | 43,763           |
| Purchase of securities                                                                         | (252,561)                          | (190,487)        |
| Loan origination and payments, net                                                             | (62,860)                           | (42,318)         |
| Purchase of bank owned life insurance                                                          | (1,000)                            | (5,000)          |
| Acquisition of consumer discount company                                                       | (1,248)                            | 0                |
| Purchase of FHLB and other equity interests                                                    | (218)                              | (179)            |
| Purchase of premises and equipment                                                             | (1,711)                            | (1,483)          |
| Proceeds from the sale of premises and equipment and foreclosed assets                         | 867                                | 245              |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                                                   | <b>(143,737)</b>                   | <b>(117,075)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                                   |                                    |                  |
| Net change in:                                                                                 |                                    |                  |
| Checking, money market and savings accounts                                                    | 174,031                            | 215,087          |
| Certificates of deposit                                                                        | (47,612)                           | (80,393)         |
| Proceeds from sale of treasury stock                                                           | 528                                | 922              |
| Proceeds from exercise of stock options                                                        | 374                                | 0                |
| Cash dividends paid                                                                            | (6,156)                            | (6,085)          |
| Proceeds from long-term borrowings                                                             | 0                                  | 350              |

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|                                                      |           |           |
|------------------------------------------------------|-----------|-----------|
| Repayment of long-term borrowings                    | (120)     | (95)      |
| Net change in short-term borrowings                  | 0         | (31,338)  |
| NET CASH PROVIDED BY FINANCING ACTIVITIES            | 121,045   | 98,448    |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (6,757)   | 3,744     |
| CASH AND CASH EQUIVALENTS, Beginning                 | 39,703    | 37,432    |
| CASH AND CASH EQUIVALENTS, Ending                    | \$ 32,946 | \$ 41,176 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:    |           |           |
| Cash paid during the period for:                     |           |           |
| Interest                                             | \$ 11,807 | \$ 13,626 |
| Income taxes                                         | \$ 5,418  | \$ 3,317  |
| SUPPLEMENTAL NONCASH DISCLOSURES:                    |           |           |
| Transfers to other real estate owned                 | \$ 680    | \$ 93     |
| Grant of restricted stock awards from treasury stock | \$ 419    | \$ 266    |

See Notes to Consolidated Financial Statements

**Table of Contents**

**CNB FINANCIAL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. BASIS OF PRESENTATION**

The accompanying consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission ( SEC ) and in compliance with accounting principles generally accepted in the United States of America ( GAAP ). Because this report is based on an interim period, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted.

In the opinion of management of the registrant, the accompanying consolidated financial statements as of September 30, 2012 and for the three and nine month periods ended September 30, 2012 and 2011 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations for the periods presented. The financial performance reported for CNB Financial Corporation (the Corporation ) for the three and nine month periods ended September 30, 2012 is not necessarily indicative of the results to be expected for the full year. This information should be read in conjunction with the Corporation s Annual Report on Form 10-K for the period ended December 31, 2011 (the 2011 Form 10-K ). All dollar amounts are stated in thousands, except share and per share data.

**2. STOCK COMPENSATION**

The Corporation has a stock incentive plan for key employees and independent directors. The stock incentive plan, which is administered by a committee of the Board of Directors, provides for aggregate grants of up to 500,000 shares of common stock in the form of nonqualified options or restricted stock. For key employees, the plan vesting is one-fourth of the granted options or restricted stock per year beginning one year after the grant date, with 100% vested on the fourth anniversary of the grant. For independent directors, the vesting schedule is one-third of the granted options per year beginning one year after the grant date, with 100% vested on the third anniversary of the grant.

At September 30, 2012, there was no unrecognized compensation cost related to nonvested stock options granted under this plan and no stock options were granted during the three or nine month periods ended September 30, 2012. At September 30, 2012 and December 31, 2011, the Corporation had 79,250 and 107,375 stock options that were fully vested and exercisable.

Compensation expense for the restricted stock awards is recognized over the requisite service period noted above based on the fair value of the shares at the date of grant. Nonvested restricted stock awards are recorded as a reduction of additional paid-in-capital in shareholders equity until earned. Compensation expense resulting from these restricted stock awards was \$73 and \$205 for the three and nine months ended September 30, 2012, and \$62 and \$164 for the three and nine months ended September 30, 2011. As of September 30, 2012, there was \$608 of total unrecognized compensation cost related to nonvested restricted stock awards.

A summary of changes in nonvested restricted stock awards for the three months ended September 30, 2012 follows:

|                                  | Shares | Weighted Average<br>Grant Date Fair Value |
|----------------------------------|--------|-------------------------------------------|
| Nonvested at beginning of period | 52,829 | \$ 15.39                                  |
| Granted                          | 0      | 0                                         |
| Vested                           | 200    | 15.29                                     |
| Forfeited                        | 0      | 0                                         |

|                            |        |    |       |
|----------------------------|--------|----|-------|
| Nonvested at end of period | 52,629 | \$ | 15.39 |
|----------------------------|--------|----|-------|

**Table of Contents**

A summary of changes in nonvested restricted stock awards for the nine months ended September 30, 2012 follows:

|                                  | Shares  | Weighted Average<br>Grant Date Fair Value |
|----------------------------------|---------|-------------------------------------------|
| Nonvested at beginning of period | 35,613  | \$ 15.08                                  |
| Granted                          | 26,900  | 15.57                                     |
| Vested                           | (9,884) | 14.78                                     |
| Forfeited                        | 0       | 0                                         |
| Nonvested at end of period       | 52,629  | \$ 15.39                                  |

**3. FAIR VALUE****Fair Value Option**

Management elected to adopt the fair value option for its investment in certain securities that are traded frequently and do not meet the criteria to be classified as available for sale or held to maturity. With limited exceptions, these securities are common stocks or mutual funds that are classified as Level 1 in the fair value hierarchy.

Fair value changes attributable to unrealized gains that were included in earnings for the three and nine months ended September 30, 2012 were \$213 and \$237, respectively. Fair value changes attributable to unrealized losses that were included in earnings for the three and nine months ended September 30, 2011 were (\$313) and (\$226), respectively. Realized gains on the sale of securities for which the fair value option was elected were \$62 and \$218 during the three and nine months ended September 30, 2012. Realized gains on the sale of securities for which the fair value option was elected were \$0 and \$10 during the three and nine months ended September 30, 2011.

Dividend income is recorded based on cash dividends and comprises the Dividends line item in the accompanying consolidated statement of income. Dividend income was \$16 and \$47 for the three and nine months ended September 30, 2012 and \$8 and \$23 for the three and nine months ended September 30, 2011.

**Fair Value Measurement**

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy has also been established which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following three levels of inputs are used to measure fair value:

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

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

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

The fair values of most trading securities and securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair value of one corporate





**Table of Contents**

bond held by the Corporation has been determined by using Level 3 inputs. The Corporation has engaged a valuation expert to price this security using a proprietary model, which incorporates assumptions about certain factors that market participants would use in pricing the securities, including bid/ask spreads and liquidity and credit premiums.

Trust preferred securities which are issued by financial institutions and insurance companies are priced using Level 3 inputs. The decline in the level of observable inputs and market activity in this class of investments by the measurement date has been significant and resulted in unreliable external pricing. Broker pricing and bid/ask spreads, when available, vary widely, and the once-active market has become comparatively inactive. The Corporation engaged a third party consultant who has developed a model for pricing these securities. Information such as historical and current performance of the underlying collateral, deferral and default rates, collateral coverage ratios, break in yield calculations, cash flow projections, liquidity and credit premiums required by a market participant, and financial trend analysis with respect to the individual issuing financial institutions and insurance companies are utilized in determining individual security valuations. Due to the current market conditions as well as the limited trading activity of these securities, the market value of the securities is highly sensitive to assumption changes and market volatility.

The Corporation's derivative instrument is an interest rate swap that is similar to those that trade in liquid markets. As such, significant fair value inputs can generally be verified and do not typically involve significant management judgments (Level 2 inputs).

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals prepared by third-parties. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Management also adjusts appraised values based on the length of time that has passed since the appraisal date and other factors. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Assets and liabilities measured at fair value on a recurring basis are as follows at September 30, 2012 and December 31, 2011:

|                                       |                    | Fair Value Measurements at September 30, 2012 Using |                                                                            |                                                     |                                                    |         |         |       |       |
|---------------------------------------|--------------------|-----------------------------------------------------|----------------------------------------------------------------------------|-----------------------------------------------------|----------------------------------------------------|---------|---------|-------|-------|
|                                       |                    | Total                                               | Quoted Prices in<br>Active Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |         |         |       |       |
| Description                           |                    |                                                     |                                                                            |                                                     |                                                    |         |         |       |       |
| Assets:                               |                    |                                                     |                                                                            |                                                     |                                                    |         |         |       |       |
| Securities Available For Sale:        |                    |                                                     |                                                                            |                                                     |                                                    |         |         |       |       |
| U.S. Treasury                         | \$                 | 5,050                                               | \$                                                                         | 0                                                   | \$                                                 | 5,050   | \$      | 0     |       |
| U.S. Government sponsored entities    |                    | 119,753                                             |                                                                            | 0                                                   |                                                    | 119,753 |         | 0     |       |
| States and political subdivisions     |                    | 172,238                                             |                                                                            | 0                                                   |                                                    | 172,238 |         | 0     |       |
| Residential mortgage and asset backed |                    | 357,804                                             |                                                                            | 3,560                                               |                                                    | 354,244 |         | 0     |       |
| Commercial mortgage and asset backed  |                    | 1,947                                               |                                                                            | 0                                                   |                                                    | 1,947   |         | 0     |       |
| Corporate notes and bonds             |                    | 14,519                                              |                                                                            | 0                                                   |                                                    | 12,534  |         | 1,985 |       |
| Pooled trust preferred                |                    | 360                                                 |                                                                            | 0                                                   |                                                    | 0       |         | 360   |       |
| Pooled SBA                            |                    | 46,061                                              |                                                                            | 46,061                                              |                                                    | 0       |         | 0     |       |
| Other securities                      |                    | 1,552                                               |                                                                            | 1,552                                               |                                                    | 0       |         | 0     |       |
| Total Securities Available For Sale   |                    | \$                                                  | 719,284                                                                    | \$                                                  | 51,173                                             | \$      | 665,766 | \$    | 2,345 |
| Trading Securities:                   |                    |                                                     |                                                                            |                                                     |                                                    |         |         |       |       |
| Equity securities                     | financial services | \$                                                  | 555                                                                        | \$                                                  | 555                                                | \$      | 0       | \$    | 0     |
| Equity securities                     | industrials        |                                                     | 541                                                                        |                                                     | 541                                                |         | 0       |       | 0     |
| Equity securities                     | health care        |                                                     | 433                                                                        |                                                     | 433                                                |         | 0       |       | 0     |
| Certificates of deposit               |                    |                                                     | 407                                                                        |                                                     | 407                                                |         | 0       |       | 0     |
| Equity securities                     | energy             |                                                     | 317                                                                        |                                                     | 317                                                |         | 0       |       | 0     |
| International mutual funds            |                    |                                                     | 267                                                                        |                                                     | 267                                                |         | 0       |       | 0     |
| Equity securities                     | materials          |                                                     | 184                                                                        |                                                     | 184                                                |         | 0       |       | 0     |
| Large cap growth mutual funds         |                    |                                                     | 157                                                                        |                                                     | 157                                                |         | 0       |       | 0     |

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|                                            |              |              |            |          |
|--------------------------------------------|--------------|--------------|------------|----------|
| Equity securities - consumer staples       | 132          | 132          | 0          | 0        |
| Large cap value mutual funds               | 106          | 106          | 0          | 0        |
| Corporate notes and bonds                  | 102          | 0            | 102        | 0        |
| Money market mutual funds                  | 96           | 96           | 0          | 0        |
| Equity securities - technology             | 92           | 92           | 0          | 0        |
| Real estate investment trust mutual funds  | 66           | 66           | 0          | 0        |
| U.S. Government sponsored entities         | 58           | 0            | 58         | 0        |
| Equity securities - consumer discretionary | 54           | 54           | 0          | 0        |
| Small cap mutual funds                     | 27           | 27           | 0          | 0        |
| Mid cap mutual funds                       | 26           | 26           | 0          | 0        |
| <br>Total Trading Securities               | <br>\$ 3,620 | <br>\$ 3,460 | <br>\$ 160 | <br>\$ 0 |
| <b>Liabilities:</b>                        |              |              |            |          |
| Interest rate swaps                        | \$ (1,848)   | \$ 0         | \$ (1,848) | \$ 0     |

## Table of Contents

|                                           |            | Fair Value Measurements at December 31, 2011 Using                         |                                                     |                                                    |
|-------------------------------------------|------------|----------------------------------------------------------------------------|-----------------------------------------------------|----------------------------------------------------|
|                                           |            | Quoted Prices in<br>Active Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Description                               | Total      |                                                                            |                                                     |                                                    |
| Assets:                                   |            |                                                                            |                                                     |                                                    |
| Securities Available For Sale:            |            |                                                                            |                                                     |                                                    |
| U.S. Treasury                             | \$ 8,130   | \$ 0                                                                       | \$ 8,130                                            | \$ 0                                               |
| U.S. Government sponsored entities        | 107,492    | 2,000                                                                      | 105,492                                             | 0                                                  |
| States and political subdivisions         | 158,437    | 4,655                                                                      | 153,782                                             | 0                                                  |
| Residential mortgage and asset backed     | 300,126    | 8,577                                                                      | 291,549                                             | 0                                                  |
| Commercial mortgage and asset backed      | 2,122      | 0                                                                          | 2,122                                               | 0                                                  |
| Corporate notes and bonds                 | 13,860     | 0                                                                          | 11,800                                              | 2,060                                              |
| Pooled trust preferred                    | 340        | 0                                                                          | 0                                                   | 340                                                |
| Pooled SBA                                | 46,056     | 46,056                                                                     | 0                                                   | 0                                                  |
| Other securities                          | 1,544      | 1,544                                                                      | 0                                                   | 0                                                  |
|                                           |            |                                                                            |                                                     |                                                    |
| Total Securities Available For Sale       | \$ 638,107 | \$ 62,832                                                                  | \$ 572,875                                          | \$ 2,400                                           |
|                                           |            |                                                                            |                                                     |                                                    |
| Trading Securities:                       |            |                                                                            |                                                     |                                                    |
| Equity securities financial services      | \$ 779     | \$ 779                                                                     | \$ 0                                                | \$ 0                                               |
| Equity securities industrials             | 324        | 324                                                                        | 0                                                   | 0                                                  |
| International mutual funds                | 257        | 257                                                                        | 0                                                   | 0                                                  |
| Certificates of deposit                   | 255        | 255                                                                        | 0                                                   | 0                                                  |
| Money market mutual funds                 | 241        | 241                                                                        | 0                                                   | 0                                                  |
| Equity securities health care             | 204        | 204                                                                        | 0                                                   | 0                                                  |
| Equity securities - utilities             | 197        | 197                                                                        | 0                                                   | 0                                                  |
| Large cap growth mutual funds             | 145        | 145                                                                        | 0                                                   | 0                                                  |
| Equity securities consumer staples        | 145        | 145                                                                        | 0                                                   | 0                                                  |
| Equity securities consumer discretionary  | 126        | 126                                                                        | 0                                                   | 0                                                  |
| Large cap value mutual funds              | 105        | 105                                                                        | 0                                                   | 0                                                  |
| Corporate notes and bonds                 | 100        | 0                                                                          | 100                                                 | 0                                                  |
| Equity securities technology              | 75         | 75                                                                         | 0                                                   | 0                                                  |
| Equity securities energy                  | 72         | 72                                                                         | 0                                                   | 0                                                  |
| Real estate investment trust mutual funds | 68         | 68                                                                         | 0                                                   | 0                                                  |
| U.S. Government sponsored entities        | 55         | 0                                                                          | 55                                                  | 0                                                  |
| Equity securities materials               | 37         | 37                                                                         | 0                                                   | 0                                                  |
| Small cap mutual funds                    | 25         | 25                                                                         | 0                                                   | 0                                                  |
| Mid cap mutual funds                      | 23         | 23                                                                         | 0                                                   | 0                                                  |
|                                           |            |                                                                            |                                                     |                                                    |
| Total Trading Securities                  | \$ 3,233   | \$ 3,078                                                                   | \$ 155                                              | \$ 0                                               |
|                                           |            |                                                                            |                                                     |                                                    |
| Liabilities:                              |            |                                                                            |                                                     |                                                    |
| Interest rate swaps                       | \$ (1,669) | \$ 0                                                                       | \$ (1,669)                                          | \$ 0                                               |

## Table of Contents

The table below presents a reconciliation and income statement classification of gains and losses for all securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended September 30, 2012:

|                                                     | Corporate<br>notes and<br>bonds | Pooled<br>trust<br>preferred |
|-----------------------------------------------------|---------------------------------|------------------------------|
| Balance, July 1, 2012                               | \$ 2,071                        | \$ 360                       |
| Total gains or (losses):                            |                                 |                              |
| Included in other comprehensive income (unrealized) | (86)                            | 0                            |
| Balance, September 30, 2012                         | \$ 1,985                        | \$ 360                       |

The table below presents a reconciliation and income statement classification of gains and losses for all securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2012:

|                                                     | Corporate<br>notes and<br>Bonds | Pooled<br>trust<br>preferred |
|-----------------------------------------------------|---------------------------------|------------------------------|
| Balance, January 1, 2012                            | \$ 2,060                        | \$ 340                       |
| Total gains or (losses):                            |                                 |                              |
| Included in other comprehensive income (unrealized) | (75)                            | 20                           |
| Balance, September 30, 2012                         | \$ 1,985                        | \$ 360                       |

The table below presents a reconciliation and income statement classification of gains and losses for all securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended September 30, 2011:

|                                                     | Residential<br>mortgage and<br>asset backed | Corporate<br>notes and<br>bonds | Pooled<br>trust<br>preferred |
|-----------------------------------------------------|---------------------------------------------|---------------------------------|------------------------------|
| Balance, July 1, 2011                               | \$ 3,988                                    | \$ 1,860                        | \$ 1,362                     |
| Transfers out of Level 3 (a) (b)                    | (3,988)                                     | 0                               | 0                            |
| Total gains or losses:                              |                                             |                                 |                              |
| included in other comprehensive income (unrealized) | 0                                           | 0                               | (130)                        |
| Purchases, issuances, sales and settlements         | 0                                           | 0                               | (5)                          |
| Balance, September 30, 2011                         | \$ 0                                        | \$ 1,860                        | \$ 1,227                     |

(a) Transferred from Level 3 to Level 2 since observable market data became available to value the security.

(b) The Corporation's policy is to recognize transfers in and transfers out as of the actual date of the event or change in circumstances that caused the transfer.

The table below presents a reconciliation and income statement classification of gains and losses for all securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2011:

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|                                                     | Residential<br>mortgage and<br>asset backed | Corporate<br>notes and<br>bonds | U.S. Gov t<br>Sponsored<br>Entities | Pooled<br>trust<br>preferred |
|-----------------------------------------------------|---------------------------------------------|---------------------------------|-------------------------------------|------------------------------|
| Balance, January 1, 2011                            | \$ 2,269                                    | \$ 1,240                        | \$ 2,000                            | \$ 1,292                     |
| Transfers out of Level 3 (a)(b)                     | (3,988)                                     | 0                               | (2,000)                             | 0                            |
| Total gains or losses:                              |                                             |                                 |                                     |                              |
| Included in earnings (realized)                     | 0                                           | 0                               | 0                                   | (398)                        |
| Included in other comprehensive income (unrealized) | 0                                           | 620                             | 0                                   | 338                          |
| Purchases, issuances, sales, and settlements:       |                                             |                                 |                                     |                              |
| Purchases                                           | 1,917                                       | 0                               | 0                                   | 0                            |
| Settlements                                         | (198)                                       | 0                               | 0                                   | (5)                          |
| Balance, September 30, 2011                         | \$ 0                                        | \$ 1,860                        | \$ 0                                | \$ 1,227                     |

- (c) Transferred from Level 3 to Level 2 since observable market data became available to value the security.
- (d) The Corporation's policy is to recognize transfers in and transfers out as of the actual date of the event or change in circumstances that caused the transfer.

## Table of Contents

The unrealized losses reported in earnings for the nine months ended September 30, 2011 for Level 3 assets that are still held at the balance sheet date relate to pooled trust preferred securities deemed to be other-than-temporarily impaired.

The following table presents quantitative information about Level 3 fair value measurements at September 30, 2012:

|                           | Fair value | Valuation<br>Technique      | Unobservable             |                                              |
|---------------------------|------------|-----------------------------|--------------------------|----------------------------------------------|
|                           |            |                             | Inputs                   | Input<br>Utilized                            |
| Corporate notes and bonds | \$ 1,985   | Discounted<br><br>cash flow | Constant prepayment rate | 0%                                           |
|                           |            |                             | Probability of default   | 0%                                           |
|                           |            |                             | Discount rate            | 9.6%                                         |
| Pooled trust preferred    | \$ 360     | Discounted<br><br>cash flow | Collateral default rate  | 2% annually for 2 years;<br>0.36% thereafter |
|                           |            |                             |                          | 17%                                          |
|                           |            |                             | Discount rate            | 10%, lagged 2 years                          |
|                           |            |                             | Recovery probability     |                                              |

The significant unobservable inputs used in the fair value measurement of the Corporation's corporate notes and bonds are prepayment rates, probability of default, and discount rate. Significant increases/(decreases) in any of those inputs in isolation would result in a significantly reduced/increased fair value measurement. The significant unobservable inputs used in the fair value measurement of the Corporation's pooled trust preferred securities are collateral default rate, discount rate, and recovery probability. Prepayment rates are also estimated for pooled trust preferred securities and vary depending on the asset size of the company that issued the security and whether the issue is fixed rate or variable rate; however, the overall effect of prepayment rates on fair value is not material. Significant increases in specific-issuer default assumptions or decreases in specific-issuer recovery assumptions would result in a significantly lower fair value measurement. Conversely, decreases in specific-issuer default assumptions or increases in specific-issuer recovery assumptions would result in a higher fair value measurement.

During the three months ended September 30, 2012 residential mortgage and asset backed securities totaling \$3,148 that were reported as Level 1 securities as of the beginning of the period were transferred to the Level 2 category. There were no transfers of securities from Level 1 to Level 2 during the three months ended September 30, 2011.

During the nine months ended September 30, 2012 and 2011, the following available for sale securities reported as Level 1 securities as of the beginning of the period were transferred to the Level 2 category:

|                                       | 2012      | 2011      |
|---------------------------------------|-----------|-----------|
| U.S. Government sponsored entities    | \$ 2,000  | \$ 2,000  |
| States and political subdivisions     | 4,655     | 4,750     |
| Residential mortgage and asset backed | 8,577     | 20,405    |
| Total                                 | \$ 15,232 | \$ 27,155 |

These securities were transferred from the Level 1 category to the Level 2 category since there were no longer quoted prices for identical assets in active markets that the Corporation had the ability to access. During the nine months ended September 30, 2011, two pooled SBA securities that were classified as Level 2 securities at December 31, 2010 were transferred to the Level 1 category. The fair value on the date of transfer was \$3,437. There were no transfers of securities from the Level 2 category to the Level 1 category during the three months ended September 30, 2011. There were no transfers of securities from the Level 2 category to the Level 1 category during the three and nine months ended September 30, 2012. The Corporation's policy for determining when a transfer between the Level 1 and Level 2 categories has occurred is to monitor and report such transfers as of each quarterly reporting period.





## Table of Contents

Assets and liabilities measured at fair value on a non-recurring basis are as follows at September 30, 2012 and December 31, 2011:

| Fair Value Measurements at September 30, 2012 |          |                                                                               |      |                                                    |
|-----------------------------------------------|----------|-------------------------------------------------------------------------------|------|----------------------------------------------------|
| Using                                         |          |                                                                               |      |                                                    |
| Description                                   | Total    | Quoted Prices in<br>Active Markets for<br>Identical<br>Assets<br>(Level<br>1) |      |                                                    |
|                                               |          | Significant Other<br>Observable Inputs<br>(Level 2)                           |      | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:                                       |          |                                                                               |      |                                                    |
| Impaired loans:                               |          |                                                                               |      |                                                    |
| Commercial mortgages                          | \$ 8,327 | \$ 0                                                                          | \$ 0 | \$ 8,327                                           |
| Commercial, industrial, and agricultural      | 3,945    | 0                                                                             | 0    | 3,945                                              |
| Residential real estate                       | 419      | 0                                                                             | 0    | 419                                                |

| Fair Value Measurements at December 31, 2011 |          |                                                                               |      |                                                    |
|----------------------------------------------|----------|-------------------------------------------------------------------------------|------|----------------------------------------------------|
| Using                                        |          |                                                                               |      |                                                    |
| Description                                  | Total    | Quoted Prices in<br>Active Markets for<br>Identical<br>Assets<br>(Level<br>1) |      |                                                    |
|                                              |          | Significant Other<br>Observable Inputs<br>(Level 2)                           |      | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:                                      |          |                                                                               |      |                                                    |
| Impaired loans:                              |          |                                                                               |      |                                                    |
| Commercial mortgages                         | \$ 7,219 | \$ 0                                                                          | \$ 0 | \$ 7,219                                           |
| Commercial, industrial, and agricultural     | 3,190    | 0                                                                             | 0    | 3,190                                              |
| Residential real estate                      | 105      | 0                                                                             | 0    | 105                                                |

Impaired loans, which are measured for impairment using the fair value of collateral for collateral dependent loans, had a principal balance of \$14,678 with a valuation allowance of \$1,987 as of September 30, 2012, resulting in an additional provision for loan losses of \$756 and \$1,544 for the corresponding three and nine months then ended. Impaired loans had a principal balance of \$22,384 with a valuation allowance of \$1,493 as of December 31, 2011, and an additional provision for loan losses of \$530 and \$782 was recorded for the three and nine months ended September 30, 2011.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2012:

|                |                                          |            | Unobservable              |                                                                                      |  |
|----------------|------------------------------------------|------------|---------------------------|--------------------------------------------------------------------------------------|--|
| Impaired loans |                                          | Fair value | Valuation<br>Technique    | Inputs                                                                               |  |
|                |                                          |            |                           | Range<br>(Weighted Average)                                                          |  |
| Impaired loans | commercial mortgages                     | \$ 8,327   | Sales comparison approach | Negative adjustment for changes in market conditions since appraisal                 |  |
| Impaired loans | commercial, industrial, and agricultural | 3,945      | Income approach           | Negative adjustment for changes in net operating income expectations since appraisal |  |
| Impaired loans | residential real estate                  | 419        | Sales comparison approach | Negative adjustment for changes in market conditions since appraisal                 |  |

## Table of Contents

### Fair Value of Financial Instruments

The following table presents the carrying amount and fair value of financial instruments at September 30, 2012:

|                                                 | Carrying<br>Amount | Fair Value Measurement Using: |              |          | Total<br>Fair Value |
|-------------------------------------------------|--------------------|-------------------------------|--------------|----------|---------------------|
|                                                 |                    | Level 1                       | Level 2      | Level 3  |                     |
| <b>ASSETS</b>                                   |                    |                               |              |          |                     |
| Cash and cash equivalents                       | \$ 32,946          | \$ 32,946                     | \$ 0         | \$ 0     | \$ 32,946           |
| Interest bearing time deposits with other banks | 225                | 0                             | 225          | 0        | 225                 |
| Securities available for sale                   | 719,284            | 51,173                        | 665,766      | 2,345    | 719,284             |
| Trading securities                              | 3,620              | 3,460                         | 160          | 0        | 3,620               |
| Loans held for sale                             | 3,847              | 0                             | 3,938        | 0        | 3,938               |
| Net loans                                       | 896,568            | 0                             | 0            | 922,833  | 922,833             |
| FHLB and other equity interests                 | 6,755              | N/A                           | N/A          | N/A      | N/A                 |
| Accrued interest receivable                     | 7,357              | 288                           | 3,753        | 3,316    | 7,357               |
| <b>LIABILITIES</b>                              |                    |                               |              |          |                     |
| Deposits                                        | \$ (1,480,270)     | \$ (1,259,828)                | \$ (223,935) | \$ 0     | \$ (1,483,763)      |
| FHLB and other borrowings                       | (74,336)           | 0                             | (77,364)     | 0        | (77,364)            |
| Subordinated debentures                         | (20,620)           | 0                             | 0            | (11,049) | (11,049)            |
| Interest rate swaps                             | (1,848)            | 0                             | (1,848)      | 0        | (1,848)             |
| Accrued interest payable                        | (1,041)            | (291)                         | (732)        | (18)     | (1,041)             |

The following table presents the carrying amount and fair value of financial instruments at December 31, 2011:

|                                                 | Carrying<br>Amount | Fair<br>Value  |
|-------------------------------------------------|--------------------|----------------|
| <b>ASSETS</b>                                   |                    |                |
| Cash and cash equivalents                       | \$ 39,703          | \$ 39,703      |
| Interest bearing time deposits with other banks | 224                | 229            |
| Securities available for sale                   | 638,107            | 638,107        |
| Trading securities                              | 3,233              | 3,233          |
| Loans held for sale                             | 1,442              | 1,470          |
| Net loans                                       | 837,268            | 862,389        |
| FHLB and other equity interests                 | 6,537              | N/A            |
| Accrued interest receivable                     | 6,567              | 6,567          |
| <b>LIABILITIES</b>                              |                    |                |
| Deposits                                        | \$ (1,353,851)     | \$ (1,357,415) |
| FHLB and other borrowings                       | (74,456)           | (83,042)       |
| Subordinated debentures                         | (20,620)           | (10,906)       |
| Interest rate swaps                             | (1,669)            | (1,669)        |
| Accrued interest payable                        | (1,308)            | (1,308)        |

The methods and assumptions, not otherwise presented, used to estimate fair values are described as follows:

**Cash and cash equivalents:** The carrying amounts of cash and cash equivalents approximate fair values and are classified as Level 1.

**Interest bearing time deposits with other banks:** The fair value of interest bearing time deposits with other banks is estimated using a discounted cash flow calculation that applies interest rates currently being offered to a schedule of aggregated expected monthly maturities, resulting in a Level 2 classification.

**Loans held for sale:** The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.



**Table of Contents**

**Loans:** For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values, resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality, resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

**FHLB and other equity interests:** It is not practical to determine the fair value of Federal Home Loan Bank stock and other equity interests due to restrictions placed on the transferability of these instruments.

**Accrued interest receivable:** The carrying amount of accrued interest receivable approximates fair value resulting in a classification that is consistent with the asset with which it is associated.

**Deposits:** The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amount), resulting in a Level 1 classification. Fair values for time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits, resulting in a Level 2 classification.

**FHLB and other borrowings:** The fair values of the Corporation's FHLB and other borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements, resulting in a Level 2 classification.

**Subordinated debentures:** The fair value of the Corporation's subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of arrangements, resulting in a Level 3 classification.

**Accrued interest payable:** The carrying amount of accrued interest payable approximates fair value resulting in a classification that is consistent with the liability with which it is associated.

While estimates of fair value are based on management's judgment of the most appropriate factors as of the balance sheet date, there is no assurance that the estimated fair values would have been realized if the assets had been disposed of or the liabilities settled at that date, since market values may differ depending on various circumstances. The estimated fair values would also not apply to subsequent dates.

In addition, other assets and liabilities that are not financial instruments, such as premises and equipment, are not included in the disclosures. Also, non-financial assets such as, among other things, the estimated earnings power of core deposits, the earnings potential of trust accounts, the trained workforce, and customer goodwill, which typically are not recognized on the balance sheet, may have value but are not included in the fair value disclosures.

**4. SECURITIES**

Securities available for sale at September 30, 2012 and December 31, 2011 are as follows:

|                                     | September 30, 2012 |                     |                      |               | December 31, 2011 |                     |                      |               |
|-------------------------------------|--------------------|---------------------|----------------------|---------------|-------------------|---------------------|----------------------|---------------|
|                                     | Amortized<br>Cost  | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
| U.S. Treasury                       | \$ 5,025           | \$ 25               | \$ 0                 | \$ 5,050      | \$ 8,064          | \$ 66               | \$ 0                 | \$ 8,130      |
| U.S. Gov't sponsored entities       | 113,591            | 6,163               | (1)                  | 119,753       | 102,258           | 5,249               | (15)                 | 107,492       |
| State & political subdivisions      | 161,138            | 11,135              | (35)                 | 172,238       | 149,685           | 8,844               | (92)                 | 158,437       |
| Residential mortgage & asset backed | 349,141            | 9,234               | (571)                | 357,804       | 292,297           | 8,043               | (214)                | 300,126       |
| Commercial mortgage & asset backed  | 1,875              | 72                  | 0                    | 1,947         | 2,077             | 45                  | 0                    | 2,122         |
| Corporate notes & bonds             | 17,366             | 40                  | (2,887)              | 14,519        | 17,358            | 50                  | (3,548)              | 13,860        |
| Pooled trust preferred              | 800                | 0                   | (440)                | 360           | 800               | 0                   | (460)                | 340           |
| Pooled SBA                          | 44,097             | 1,964               | 0                    | 46,061        | 44,851            | 1,282               | (77)                 | 46,056        |
| Other securities                    | 1,521              | 31                  | 0                    | 1,552         | 1,521             | 23                  | 0                    | 1,544         |

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|       |            |           |            |            |            |           |            |            |
|-------|------------|-----------|------------|------------|------------|-----------|------------|------------|
| Total | \$ 694,554 | \$ 28,664 | \$ (3,934) | \$ 719,284 | \$ 618,911 | \$ 23,602 | \$ (4,406) | \$ 638,107 |
|-------|------------|-----------|------------|------------|------------|-----------|------------|------------|

## Table of Contents

At September 30, 2012, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity.

Trading securities accounted for under the fair value option at September 30, 2012 and December 31, 2011 are as follows:

|                                           | September 30,<br>2012 | December 31,<br>2011 |
|-------------------------------------------|-----------------------|----------------------|
| Corporate equity securities               | \$ 2,308              | \$ 1,959             |
| Certificates of deposit                   | 407                   | 255                  |
| International mutual funds                | 267                   | 257                  |
| Large cap growth mutual funds             | 157                   | 145                  |
| Large cap value mutual funds              | 106                   | 105                  |
| Corporate notes and bonds                 | 102                   | 100                  |
| Money market mutual funds                 | 96                    | 241                  |
| Real estate investment trust mutual funds | 66                    | 68                   |
| U.S. Government sponsored entities        | 58                    | 55                   |
| Small cap mutual funds                    | 27                    | 25                   |
| Mid cap mutual funds                      | 26                    | 23                   |
| Total                                     | \$ 3,620              | \$ 3,233             |

Securities with unrealized losses at September 30, 2012 and December 31, 2011, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (in thousands):

### September 30, 2012

| Description of Securities           | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|-------------------------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|                                     | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasury                       | \$ 0                | \$ 0            | \$ 0              | \$ 0            | \$ 0       | \$ 0            |
| U.S. Government sponsored entities  | 3,091               | (1)             | 0                 | 0               | 3,091      | (1)             |
| State & political subdivisions      | 4,870               | (35)            | 0                 | 0               | 4,870      | (35)            |
| Residential mortgage & asset backed | 57,167              | (556)           | 1,181             | (15)            | 58,348     | (571)           |
| Commercial mortgage & asset backed  | 0                   | 0               | 0                 | 0               | 0          | 0               |
| Corporate notes & bonds             | 0                   | 0               | 13,632            | (2,887)         | 13,632     | (2,887)         |
| Pooled trust preferred              | 0                   | 0               | 360               | (440)           | 360        | (440)           |
| Pooled SBA                          | 0                   | 0               | 0                 | 0               | 0          | 0               |
| Other securities                    | 0                   | 0               | 0                 | 0               | 0          | 0               |
|                                     | \$ 65,128           | \$ (592)        | \$ 15,173         | \$ (3,342)      | \$ 80,301  | \$ (3,934)      |

### December 31, 2011

| Description of Securities | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|---------------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|                           | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasury             | \$ 0                | \$ 0            | \$ 0              | \$ 0            | \$ 0       | \$ 0            |

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|                                     |           |          |           |            |           |            |
|-------------------------------------|-----------|----------|-----------|------------|-----------|------------|
| U.S. Gov t sponsored entities       | 7,671     | (15)     | 0         | 0          | 7,671     | (15)       |
| State & political subdivisions      | 5,314     | (92)     | 0         | 0          | 5,314     | (92)       |
| Residential mortgage & asset backed | 36,626    | (162)    | 9,485     | (52)       | 46,111    | (214)      |
| Commercial mortgage & asset backed  | 0         | 0        | 0         | 0          | 0         | 0          |
| Corporate notes & bonds             | 2,860     | (139)    | 8,841     | (3,409)    | 11,701    | (3,548)    |
| Pooled trust preferred              | 0         | 0        | 340       | (460)      | 340       | (460)      |
| Pooled SBA                          | 8,139     | (77)     | 0         | 0          | 8,139     | (77)       |
| Other securities                    | 0         | 0        | 0         | 0          | 0         | 0          |
|                                     | \$ 60,610 | \$ (485) | \$ 18,666 | \$ (3,921) | \$ 79,276 | \$ (4,406) |

## Table of Contents

The Corporation evaluates securities for other-than-temporary impairment on a quarterly basis, or more frequently when economic or market conditions warrant such an evaluation.

At September 30, 2012, the Corporation held one structured pooled trust preferred security with an adjusted amortized cost of \$800 and a fair value of \$360. The Corporation evaluated this security for other-than-temporary impairment by estimating the cash flows expected to be received, taking into account future estimated levels of deferrals and defaults by the underlying issuers, and discounting those cash flows at the appropriate accounting yield. For the three and nine months ended September 30, 2012, no other-than-temporary impairment was required to be realized in earnings. For the three and nine months ended September 30, 2011, other-than-temporary impairment of \$0 and \$398, respectively, was realized in earnings. At September 30, 2012 and December 31, 2011, the Corporation held four structured pooled trust preferred securities with an adjusted amortized cost of zero.

A roll-forward of the other-than-temporary impairment amount related to credit losses for the three and nine months ended September 30, 2012 is as follows:

|                                                                                                                                                                      |          |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------|
| Balance of credit losses on debt securities for which a portion of other-than-temporary impairment was recognized in other comprehensive income, beginning of period | \$ 4,054 |
| Additional credit loss for which other-than-temporary impairment was not previously recognized                                                                       | 0        |
| Additional credit loss for which other-than-temporary impairment was previously recognized                                                                           | 0        |
| Balance of credit losses on debt securities for which a portion of other-than-temporary impairment was recognized in other comprehensive income, end of period       | \$ 4,054 |

A roll-forward of the other-than-temporary impairment amount related to credit losses for the three months ended September 30, 2011 is as follows:

|                                                                                                                                                                      |          |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------|
| Balance of credit losses on debt securities for which a portion of other-than-temporary impairment was recognized in other comprehensive income, beginning of period | \$ 4,054 |
| Additional credit loss for which other-than-temporary impairment was not previously recognized                                                                       | 0        |
| Additional credit loss for which other-than-temporary impairment was previously recognized                                                                           | 0        |
| Balance of credit losses on debt securities for which a portion of other-than-temporary impairment was recognized in other comprehensive income, end of period       | \$ 4,054 |

A roll-forward of the other-than-temporary impairment amount related to credit losses for the nine months ended September 30, 2011 is as follows:

|                                                                                                                                                                      |          |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------|
| Balance of credit losses on debt securities for which a portion of other-than-temporary impairment was recognized in other comprehensive income, beginning of period | \$ 3,656 |
| Additional credit loss for which other-than-temporary impairment was not previously recognized                                                                       | 0        |
| Additional credit loss for which other-than-temporary impairment was previously recognized                                                                           | 398      |
| Balance of credit losses on debt securities for which a portion of other-than-temporary impairment was recognized in other comprehensive income, end of period       | \$ 4,054 |

Due to the insignificance of the adjusted amortized cost and other-than-temporary impairment charges to the consolidated financial statements, no further disclosures are required with respect to the Corporation's structured pooled trust preferred securities.



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For the securities that comprise corporate notes and bonds and the securities that are issued by state and political subdivisions, management monitors publicly available financial information, such as filings with the Securities and Exchange Commission, in order to evaluate the securities for other-than-temporary impairment. For financial institution issuers, management also monitors information from quarterly call report filings that are used to generate Uniform Bank Performance Reports. When reviewing this information, management considers the financial condition and near-term prospects of the issuer and whether downgrades by bond rating agencies have occurred. Management also considers the length of time and extent to which fair value has been less than cost and the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

## Table of Contents

As of September 30, 2012 and December 31, 2011, management concluded that the securities described in the previous paragraph were not other-than-temporarily impaired for the following reasons:

There is no indication of any significant deterioration of the creditworthiness of the institutions that issued the securities.

The unrealized losses are predominantly attributable to the generally stressed condition of the financial services industry.

All contractual interest payments on the securities have been received as scheduled, and no information has come to management's attention through the processes previously described which would lead to a conclusion that future contractual payments will not be timely received.

The Corporation does not intend to sell and it is not more likely than not that it will be required to sell the securities in an unrealized loss position before recovery of its amortized cost basis.

Information pertaining to security sales is as follows:

|                                       | Proceeds | Gross Gains | Gross Losses |
|---------------------------------------|----------|-------------|--------------|
| Three months ended September 30, 2012 | \$ 4,090 | \$ 103      | \$ 0         |
| Nine months ended September 30, 2012  | 92,707   | 1,549       | (149)        |
| Three months ended September 30, 2011 | 20,153   | 109         | (25)         |
| Nine months ended September 30, 2011  | 43,763   | 255         | (97)         |

The following is a schedule of the contractual maturity of securities available for sale, excluding equity securities, at September 30, 2012:

|                                                | Amortized<br>Cost | Fair Value |
|------------------------------------------------|-------------------|------------|
| 1 year or less                                 | \$ 19,219         | \$ 19,390  |
| 1 year - 5 years                               | 83,538            | 86,308     |
| 5 years - 10 years                             | 141,782           | 152,522    |
| After 10 years                                 | 97,478            | 99,761     |
|                                                | 342,017           | 357,981    |
| Residential mortgage & asset backed securities | 349,141           | 357,804    |
| Commercial mortgage & asset backed securities  | 1,875             | 1,947      |
| Total debt securities                          | \$ 693,033        | \$ 717,732 |

Mortgage and asset backed securities are not due at a single date; periodic payments are received based on the payment patterns of the underlying collateral.

On September 30, 2012 and December 31, 2011, securities carried at \$242,884 and \$264,166, respectively, were pledged to secure public deposits and for other purposes as provided by law.

**Table of Contents****5. LOANS**

Total net loans at September 30, 2012 and December 31, 2011 are summarized as follows:

|                                          | September 30,<br>2012 | December 31,<br>2011 |
|------------------------------------------|-----------------------|----------------------|
| Commercial, industrial, and agricultural | \$ 259,906            | \$ 253,324           |
| Commercial mortgages                     | 257,031               | 242,511              |
| Residential real estate                  | 335,796               | 298,628              |
| Consumer                                 | 55,979                | 53,471               |
| Credit cards                             | 4,572                 | 4,412                |
| Overdrafts                               | 330                   | 423                  |
| Less: unearned discount                  | (3,397)               | (2,886)              |
| allowance for loan losses                | (13,649)              | (12,615)             |
| <b>Loans, net</b>                        | <b>\$ 896,568</b>     | <b>\$ 837,268</b>    |

At September 30, 2012 and December 31, 2011, net unamortized loan costs and fees of \$206 and (\$7), respectively, have been included in the carrying value of loans.

The Corporation's outstanding loans and related unfunded commitments are primarily concentrated within Central and Western Pennsylvania. The Bank attempts to limit concentrations within specific industries by utilizing dollar limitations to single industries or customers and by entering into participation agreements with third parties. Collateral requirements are established based on management's assessment of the customer.

Transactions in the allowance for loan losses for the three months ended September 30, 2012 were as follows:

|                                                      | Commercial,<br>Industrial, and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Real<br>Estate | Consumer        | Credit<br>Cards | Overdrafts    | Total            |
|------------------------------------------------------|------------------------------------------------|-------------------------|-------------------------------|-----------------|-----------------|---------------|------------------|
| Allowance for loan losses, July 1, 2012              | \$ 5,115                                       | \$ 4,553                | \$ 2,225                      | \$ 1,568        | \$ 81           | \$ 148        | \$ 13,690        |
| Charge-offs                                          | (751)                                          | (165)                   | (7)                           | (252)           | (22)            | (80)          | (1,277)          |
| Recoveries                                           | 6                                              | 0                       | 1                             | 18              | 1               | 22            | 48               |
| Provision (benefit) for loan losses                  | 103                                            | 504                     | 113                           | 372             | 19              | 77            | 1,188            |
| <b>Allowance for loan losses, September 30, 2012</b> | <b>\$ 4,473</b>                                | <b>\$ 4,892</b>         | <b>\$ 2,332</b>               | <b>\$ 1,706</b> | <b>\$ 79</b>    | <b>\$ 167</b> | <b>\$ 13,649</b> |

Transactions in the allowance for loan losses for the nine months ended September 30, 2012 were as follows:

|                                                      | Commercial,<br>Industrial, and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Real<br>Estate | Consumer        | Credit<br>Cards | Overdrafts    | Total            |
|------------------------------------------------------|------------------------------------------------|-------------------------|-------------------------------|-----------------|-----------------|---------------|------------------|
| Allowance for loan losses, January 1, 2012           | \$ 4,511                                       | \$ 4,470                | \$ 1,991                      | \$ 1,404        | \$ 71           | \$ 168        | \$ 12,615        |
| Charge-offs                                          | (1,398)                                        | (401)                   | (231)                         | (890)           | (55)            | (197)         | (3,172)          |
| Recoveries                                           | 14                                             | 0                       | 1                             | 67              | 8               | 78            | 168              |
| Provision for loan losses                            | 1,346                                          | 823                     | 571                           | 1,125           | 55              | 118           | 4,038            |
| <b>Allowance for loan losses, September 30, 2012</b> | <b>\$ 4,473</b>                                | <b>\$ 4,892</b>         | <b>\$ 2,332</b>               | <b>\$ 1,706</b> | <b>\$ 79</b>    | <b>\$ 167</b> | <b>\$ 13,649</b> |



## Table of Contents

Transactions in the allowance for loan losses for the three months ended September 30, 2011 were as follows:

|                                               | Commercial,<br>Industrial, and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Real<br>Estate | Consumer | Credit<br>Cards | Overdrafts | Total     |
|-----------------------------------------------|------------------------------------------------|-------------------------|-------------------------------|----------|-----------------|------------|-----------|
| Allowance for loan losses, July 1, 2011       | \$ 3,770                                       | \$ 4,399                | \$ 1,900                      | \$ 1,400 | \$ 104          | \$ 142     | \$ 11,715 |
| Charge-offs                                   | (84)                                           | (12)                    | (55)                          | (221)    | (12)            | (50)       | (434)     |
| Recoveries                                    | 3                                              |                         | 12                            | 31       | 3               | 18         | 67        |
| Provision (benefit) for loan losses           | 33                                             | 467                     | 154                           | 202      | 2               | 46         | 904       |
| Allowance for loan losses, September 30, 2011 | \$ 3,722                                       | \$ 4,854                | \$ 2,011                      | \$ 1,412 | \$ 97           | \$ 156     | \$ 12,252 |

Transactions in the allowance for loan losses for the nine months ended September 30, 2011 were as follows:

|                                               | Commercial,<br>Industrial, and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Real<br>Estate | Consumer | Credit<br>Cards | Overdrafts | Total     |
|-----------------------------------------------|------------------------------------------------|-------------------------|-------------------------------|----------|-----------------|------------|-----------|
| Allowance for loan losses, January 1, 2011    | \$ 3,517                                       | \$ 3,511                | \$ 1,916                      | \$ 1,561 | \$ 96           | \$ 219     | \$ 10,820 |
| Charge-offs                                   | (299)                                          | (100)                   | (132)                         | (683)    | (37)            | (165)      | (1,416)   |
| Recoveries                                    | 7                                              |                         | 12                            | 76       | 8               | 72         | 175       |
| Provision (benefit) for loan losses           | 497                                            | 1,443                   | 215                           | 458      | 30              | 30         | 2,673     |
| Allowance for loan losses, September 30, 2011 | \$ 3,722                                       | \$ 4,854                | \$ 2,011                      | \$ 1,412 | \$ 97           | \$ 156     | \$ 12,252 |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and is based on the Corporation's impairment method as of September 30, 2012 and December 31, 2011:

## September 30, 2012

|                                                 | Commercial,<br>Industrial, and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Real<br>Estate | Consumer  | Credit<br>Cards | Overdrafts | Total      |
|-------------------------------------------------|------------------------------------------------|-------------------------|-------------------------------|-----------|-----------------|------------|------------|
| Allowance for loan losses:                      |                                                |                         |                               |           |                 |            |            |
| Ending allowance balance attributable to loans: |                                                |                         |                               |           |                 |            |            |
| Individually evaluated for impairment           | \$ 498                                         | \$ 229                  | \$ 68                         | \$ 0      | \$ 0            | \$ 0       | \$ 795     |
| Collectively evaluated for impairment           | 3,975                                          | 3,392                   | 2,264                         | 1,706     | 79              | 167        | 11,583     |
| Modified in a troubled debt restructuring       | 0                                              | 1,271                   | 0                             | 0         | 0               | 0          | 1,271      |
| Total ending allowance balance                  | \$ 4,473                                       | \$ 4,892                | \$ 2,332                      | \$ 1,706  | \$ 79           | \$ 167     | \$ 13,649  |
| Loans:                                          |                                                |                         |                               |           |                 |            |            |
| Loans individually evaluated for impairment     | \$ 6,927                                       | \$ 7,698                | \$ 624                        | \$ 0      | \$ 0            | \$ 0       | \$ 15,249  |
| Loans collectively evaluated for impairment     | 252,694                                        | 239,235                 | 335,172                       | 55,979    | 4,572           | 330        | 887,982    |
| Loans modified in a troubled debt restructuring | 285                                            | 10,098                  | 0                             | 0         | 0               | 0          | 10,383     |
| Total ending loans balance                      | \$ 259,906                                     | \$ 257,031              | \$ 335,796                    | \$ 55,979 | \$ 4,572        | \$ 330     | \$ 913,614 |

December 31, 2011

|                                                 | Commercial,<br>Industrial, and<br>Agricultural | Commercial<br>Mortgages | Residential<br>Real<br>Estate | Consumer  | Credit<br>Cards | Overdrafts | Total      |
|-------------------------------------------------|------------------------------------------------|-------------------------|-------------------------------|-----------|-----------------|------------|------------|
| Allowance for loan losses:                      |                                                |                         |                               |           |                 |            |            |
| Ending allowance balance attributable to loans: |                                                |                         |                               |           |                 |            |            |
| Individually evaluated for impairment           | \$ 329                                         | \$ 917                  | \$ 19                         | \$ 0      | \$ 0            | \$ 0       | \$ 1,265   |
| Collectively evaluated for impairment           | 4,182                                          | 3,325                   | 1,972                         | 1,404     | 71              | 168        | 11,122     |
| Modified in a troubled debt restructuring       | 0                                              | 228                     | 0                             | 0         | 0               | 0          | 228        |
| Total ending allowance balance                  | \$ 4,511                                       | \$ 4,470                | \$ 1,991                      | \$ 1,404  | \$ 71           | \$ 168     | \$ 12,615  |
| Loans:                                          |                                                |                         |                               |           |                 |            |            |
| Loans individually evaluated for impairment     | \$ 6,115                                       | \$ 8,457                | \$ 124                        | \$ 0      | \$ 0            | \$ 0       | \$ 14,696  |
| Loans collectively evaluated for impairment     | 247,209                                        | 226,366                 | 298,504                       | 53,471    | 4,412           | 423        | 830,385    |
| Loans modified in a troubled debt restructuring | 0                                              | 7,688                   | 0                             | 0         | 0               | 0          | 7,688      |
| Total ending loans balance                      | \$ 253,324                                     | \$ 242,511              | \$ 298,628                    | \$ 53,471 | \$ 4,412        | \$ 423     | \$ 852,769 |

## Table of Contents

The following tables present information related to loans individually evaluated for impairment by portfolio segment as of September 30, 2012 and December 31, 2011 and for the three and nine months ended September 30, 2012 and 2011:

### September 30, 2012

|                                          | Unpaid Principal<br>Balance | Recorded<br>Investment | Allowance for Loan<br>Losses<br>Allocated |
|------------------------------------------|-----------------------------|------------------------|-------------------------------------------|
| With an allowance recorded:              |                             |                        |                                           |
| Commercial, industrial, and agricultural | \$ 6,616                    | \$ 3,752               | \$ 498                                    |
| Commercial mortgage                      | 6,614                       | 6,063                  | 1,500                                     |
| Residential real estate                  | 551                         | 459                    | 68                                        |
| With no related allowance recorded:      |                             |                        |                                           |
| Commercial, industrial, and agricultural | 4,217                       | 3,460                  | 0                                         |
| Commercial mortgage                      | 13,511                      | 11,733                 | 0                                         |
| Residential real estate                  | 183                         | 165                    | 0                                         |
| Total                                    | \$ 31,692                   | \$ 25,632              | \$ 2,066                                  |

### December 31, 2011

|                                          | Unpaid Principal<br>Balance | Recorded<br>Investment | Allowance for Loan<br>Losses<br>Allocated |
|------------------------------------------|-----------------------------|------------------------|-------------------------------------------|
| With an allowance recorded:              |                             |                        |                                           |
| Commercial, industrial, and agricultural | \$ 4,329                    | \$ 2,815               | \$ 462                                    |
| Commercial mortgage                      | 4,724                       | 4,065                  | 1,012                                     |
| Residential real estate                  | 187                         | 124                    | 19                                        |
| With no related allowance recorded:      |                             |                        |                                           |
| Commercial, industrial, and agricultural | 3,892                       | 3,300                  | 0                                         |
| Commercial mortgage                      | 13,839                      | 12,080                 | 0                                         |
| Residential real estate                  | 0                           | 0                      | 0                                         |
| Total                                    | \$ 26,971                   | \$ 22,384              | \$ 1,493                                  |

|                                          | Three Months Ended<br>September 30, 2012 |                                  |                                         | Nine Months Ended<br>September 30, 2012 |                                  |                                         |
|------------------------------------------|------------------------------------------|----------------------------------|-----------------------------------------|-----------------------------------------|----------------------------------|-----------------------------------------|
|                                          | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Cash<br>Basis<br>Interest<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized | Cash<br>Basis<br>Interest<br>Recognized |
| With an allowance recorded:              |                                          |                                  |                                         |                                         |                                  |                                         |
| Commercial, industrial, and agricultural | \$ 4,140                                 | \$ 0                             | \$ 0                                    | \$ 3,406                                | \$ 3                             | \$ 3                                    |
| Commercial mortgage                      | 6,180                                    | 3                                | 3                                       | 5,549                                   | 3                                | 3                                       |
| Residential real estate                  | 476                                      | 3                                | 3                                       | 322                                     | 11                               | 11                                      |
| With no related allowance recorded:      |                                          |                                  |                                         |                                         |                                  |                                         |
| Commercial, industrial, and agricultural | 3,506                                    | 0                                | 0                                       | 3,459                                   | 0                                | 0                                       |
| Commercial mortgage                      | 11,971                                   | 0                                | 0                                       | 12,016                                  | 0                                | 0                                       |

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|                         |           |      |      |           |       |       |
|-------------------------|-----------|------|------|-----------|-------|-------|
| Residential real estate | 151       | 0    | 0    | 75        | 0     | 0     |
| Total                   | \$ 26,424 | \$ 6 | \$ 6 | \$ 24,827 | \$ 17 | \$ 17 |



**Table of Contents**

|                                          | Three Months Ended<br>September 30, 2011 |                                  |                                      | Nine Months Ended<br>September 30, 2011 |                                  |                                      |
|------------------------------------------|------------------------------------------|----------------------------------|--------------------------------------|-----------------------------------------|----------------------------------|--------------------------------------|
|                                          | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Cash Basis<br>Interest<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized | Cash Basis<br>Interest<br>Recognized |
| With an allowance recorded:              |                                          |                                  |                                      |                                         |                                  |                                      |
| Commercial, industrial, and agricultural | \$ 1,097                                 | \$ 0                             | \$ 0                                 | \$ 1,330                                | \$ 0                             | \$ 0                                 |
| Commercial mortgage                      | 6,554                                    | 0                                | 0                                    | 8,050                                   | 16                               | 16                                   |
| Residential real estate                  | 175                                      | 3                                | 3                                    | 193                                     | 3                                | 3                                    |
| With no related allowance recorded:      |                                          |                                  |                                      |                                         |                                  |                                      |
| Commercial, industrial, and agricultural | 1,525                                    | 0                                | 0                                    | 1,738                                   | 0                                | 0                                    |
| Commercial mortgage                      | 7,831                                    | 0                                | 0                                    | 4,275                                   | 0                                | 0                                    |
| Residential real estate                  | 0                                        | 0                                | 0                                    | 0                                       | 0                                | 0                                    |
| <b>Total</b>                             | <b>\$ 17,182</b>                         | <b>\$ 3</b>                      | <b>\$ 3</b>                          | <b>\$ 15,586</b>                        | <b>\$ 19</b>                     | <b>\$ 19</b>                         |

The following table presents the recorded investment in nonaccrual loans and loans past due over 90 days still accruing interest by class of loans as of September 30, 2012 and December 31, 2011:

|                                          | September 30, 2012 |                                  | December 31, 2011 |                                  |
|------------------------------------------|--------------------|----------------------------------|-------------------|----------------------------------|
|                                          | Past Due           |                                  | Past Due          |                                  |
|                                          | Nonaccrual         | Over 90 Days<br>Still on Accrual | Nonaccrual        | Over 90 Days<br>Still on Accrual |
| Commercial, industrial, and agricultural | \$ 6,669           | \$ 47                            | \$ 6,949          | \$ 10                            |
| Commercial mortgages                     | 9,353              | 0                                | 8,359             | 122                              |
| Residential real estate                  | 2,532              | 136                              | 1,254             | 157                              |
| Consumer                                 | 3                  | 250                              | 5                 | 125                              |
| Credit cards                             | 0                  | 21                               | 0                 | 27                               |
| <b>Total</b>                             | <b>\$ 18,557</b>   | <b>\$ 454</b>                    | <b>\$ 16,567</b>  | <b>\$ 441</b>                    |

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

The following table presents the aging of the recorded investment in past due loans as of September 30, 2012 and December 31, 2011 by class of loans. The recorded investment in loans excludes accrued interest and loan origination fees, net due to their insignificance.

**September 30, 2012**

|                                          | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater Than<br>90 Days<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total      |
|------------------------------------------|------------------------|------------------------|-------------------------------------|-------------------|-----------------------|------------|
| Commercial, industrial, and agricultural | \$ 396                 | \$ 87                  | \$ 6,716                            | \$ 7,199          | \$ 252,707            | \$ 259,906 |
| Commercial mortgages                     | 2,093                  | 1,681                  | 7,693                               | 11,467            | 245,564               | 257,031    |
| Residential real estate                  | 1,299                  | 383                    | 2,668                               | 4,350             | 331,446               | 335,796    |
| Consumer                                 | 576                    | 234                    | 253                                 | 1,063             | 54,916                | 55,979     |
| Credit cards                             | 17                     | 21                     | 21                                  | 59                | 4,513                 | 4,572      |

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|            |          |          |           |           |            |            |
|------------|----------|----------|-----------|-----------|------------|------------|
| Overdrafts | 0        | 0        | 0         | 0         | 330        | 330        |
| Total      | \$ 4,381 | \$ 2,406 | \$ 17,351 | \$ 24,138 | \$ 889,476 | \$ 913,614 |

21

**Table of Contents****December 31, 2011**

|                                          | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater Than<br>90 Days<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total             |
|------------------------------------------|------------------------|------------------------|-------------------------------------|-------------------|-----------------------|-------------------|
| Commercial, industrial, and agricultural | \$ 239                 | \$ 53                  | \$ 6,959                            | \$ 7,251          | \$ 246,073            | \$ 253,324        |
| Commercial mortgages                     | 1,064                  | 2,620                  | 7,043                               | 10,727            | 231,784               | 242,511           |
| Residential real estate                  | 1,816                  | 682                    | 1,411                               | 3,909             | 294,719               | 298,628           |
| Consumer                                 | 392                    | 185                    | 130                                 | 707               | 52,764                | 53,471            |
| Credit cards                             | 34                     | 19                     | 27                                  | 80                | 4,332                 | 4,412             |
| Overdrafts                               | 0                      | 0                      | 0                                   | 0                 | 423                   | 423               |
| <b>Total</b>                             | <b>\$ 3,545</b>        | <b>\$ 3,559</b>        | <b>\$ 15,570</b>                    | <b>\$ 22,674</b>  | <b>\$ 830,095</b>     | <b>\$ 852,769</b> |

**Troubled Debt Restructurings**

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

A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms. Except as discussed in the following paragraph, all loans modified in troubled debt restructurings are performing in accordance with their modified terms as of September 30, 2012. No principal balances were forgiven in connection with the loan restructurings that are discussed in the following paragraphs.

The Corporation has allocated \$712 and \$228 of specific reserves to one commercial mortgage customer whose loan terms have been modified in troubled debt restructurings as of September 30, 2012 and December 31, 2011, respectively. The interest rate on the original loan was 6.60%. Due to financial difficulties experienced by the customer, the interest rate was reduced to 4.19% in the third quarter of 2010 and further reduced to 4.07% in the third quarter of 2011. In the first quarter of 2012, the customer was granted interest-only terms for six months, and in the third quarter of 2012, the customer defaulted on the loan, resulting in an additional provision for loan losses of \$503 for the three and nine months ended September 30, 2012. The loan was placed on nonaccrual status effective September 30, 2012 since collection of principal and interest was considered doubtful. This loan had a total recorded investment of \$1,657 and \$1,662 as of September 30, 2012 and December 31, 2011, respectively.

The Corporation has allocated \$100 of specific reserves to one commercial mortgage customer with two loans whose terms have been modified in a troubled debt restructuring as of September 30, 2012. The interest rates on the original loans were 6.45% and 6.47%. Due to financial difficulties experienced by the customer, the interest rates on both loans were reduced to 5.75% in the first quarter of 2012, and the maturity dates were extended to 2020 and 2024, resulting in an additional provision for loan losses of \$101 for the three and nine months ended September 30, 2012. These loans had a total recorded investment of \$1,825 as of September 30, 2012. This commercial customer has two additional mortgage loans that were deemed to be impaired as of December 31, 2011 and whose terms were modified in a troubled debt restructuring in the first quarter of 2012. The loan payments were modified to reflect a twenty year amortization with a balloon payment due after five years. These loans had a total recorded investment of \$706 and \$728 and specific reserves of \$459 and \$465 as of September 30, 2012 and December 31, 2011, respectively. No additional provision for loan losses was required to be recorded during the three and nine months ended September 30, 2012 in connection with the loan modifications.

The Corporation has a commercial mortgage customer whose loan relationships have interest-only terms that were extended during 2011. The original interest rates on the loans, which were also the market rates of interest at the time of the loan modification, were not reduced; therefore, no additional provision for loan losses was required to be recorded. These loans have a total recorded investment of \$4,520 and \$4,588 at September 30, 2012 and December 31, 2011, respectively.

In addition, the Corporation has a commercial mortgage customer whose loan relationship was restructured due to the forgiveness of accrued interest and late charges. The original interest rate on the loan, which was also the market rate of interest at the time of the loan modification, was not reduced; therefore, no additional provision for loan losses was required to be recorded. This loan has a recorded investment of \$1,390 and \$1,438 at September 30, 2012 and December 31, 2011.



## Table of Contents

The Corporation has a commercial customer with five loans whose terms were modified in a troubled debt restructuring in the first quarter of 2012 due to financial difficulties experienced by the customer. The outstanding balances on the five loans, which ranged in maturity from 2012 to 2014, were combined into one new loan with a five year term. The blended original interest rates on the loans, which were also the market rates of interest at the time of the loan modification, were not reduced; therefore no additional provision for loan losses was required to be recorded. This loan has a total recorded investment of \$285 at September 30, 2012.

The Corporation has no further loan commitments to customers whose loans are classified as a troubled debt restructuring, and, except as disclosed on the previous page, there have been no payment defaults on loans modified in a troubled debt restructuring.

## Credit Quality Indicators

The Corporation classifies commercial, industrial, and agricultural loans and commercial mortgage loans into risk categories based on relevant information about the ability of borrowers to service their debt, such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans with an outstanding balance greater than \$1 million are analyzed at least semiannually and loans with an outstanding balance of less than \$1 million are analyzed at least annually.

The Corporation uses the following definitions for risk ratings:

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

**Substandard:** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected.

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

Loans not rated as special mention, substandard, or doubtful are considered to be pass rated loans. All loans included in the following tables have been assigned a risk rating within 12 months of the balance sheet date.

### September 30, 2012

|                                          | Pass              | Special<br>Mention | Substandard      | Doubtful      | Total             |
|------------------------------------------|-------------------|--------------------|------------------|---------------|-------------------|
| Commercial, industrial, and agricultural | \$ 239,052        | \$ 1,624           | \$ 19,067        | \$ 163        | \$ 259,906        |
| Commercial mortgages                     | 232,522           | 2,844              | 20,959           | 706           | 257,031           |
| <b>Total</b>                             | <b>\$ 471,574</b> | <b>\$ 4,468</b>    | <b>\$ 40,026</b> | <b>\$ 869</b> | <b>\$ 516,937</b> |

### December 31, 2011

|                                          | Pass       | Special<br>Mention | Substandard | Doubtful | Total      |
|------------------------------------------|------------|--------------------|-------------|----------|------------|
| Commercial, industrial, and agricultural | \$ 223,457 | \$ 4,176           | \$ 25,490   | \$ 201   | \$ 253,324 |
| Commercial mortgages                     | 214,098    | 3,172              | 24,513      | 728      | 242,511    |

|       |            |          |           |        |            |
|-------|------------|----------|-----------|--------|------------|
| Total | \$ 437,555 | \$ 7,348 | \$ 50,003 | \$ 929 | \$ 495,835 |
|-------|------------|----------|-----------|--------|------------|

**Table of Contents**

The Corporation's portfolio of residential real estate and consumer loans maintained within Holiday Financial Services Corporation (Holiday), a subsidiary that offers small balance unsecured and secured loans, primarily collateralized by automobiles and equipment, to borrowers with higher risk characteristics than are typical in the Bank's consumer loan portfolio, are considered to be subprime loans.

Holiday's loan portfolio is summarized as follows at September 30, 2012 and December 31, 2011:

|                         | September 30,<br>2012 | December 31,<br>2011 |
|-------------------------|-----------------------|----------------------|
| Consumer                | \$ 21,031             | \$ 18,176            |
| Residential real estate | 987                   | 1,056                |
| Less: unearned discount | (3,397)               | (2,886)              |
| Total                   | \$ 18,621             | \$ 16,346            |

During the three months ended September 30, 2012, Holiday purchased the loans and other assets of a consumer discount company in Ebensburg, Pennsylvania. The purchase price was \$1,248 for the performing loans and customers of the business. The purchase price resulted in Holiday recording a \$75 customer relationship intangible asset which is being amortized using the straight-line method over three years. This amount is included in accrued interest receivable and other assets on the consolidated balance sheet. Goodwill of \$125 was also recorded in connection with the acquisition. Due to the insignificance of the assets acquired in relation to the consolidated financial statements as a whole, no further business combination disclosures are included in the notes to consolidated financial statements.

The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential real estate, consumer, and credit card loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential, consumer, and credit card loans based on payment activity as of September 30, 2012 and December 31, 2011:

|                | September 30, 2012         |           |                 | December 31, 2011          |           |                 |
|----------------|----------------------------|-----------|-----------------|----------------------------|-----------|-----------------|
|                | Residential<br>Real Estate | Consumer  | Credit<br>Cards | Residential<br>Real Estate | Consumer  | Credit<br>Cards |
| Performing     | \$ 333,128                 | \$ 55,726 | \$ 4,551        | \$ 297,217                 | \$ 53,341 | \$ 4,385        |
| Non-performing | 2,668                      | 253       | 21              | 1,411                      | 130       | 27              |
| Total          | \$ 335,796                 | \$ 55,979 | \$ 4,572        | \$ 298,628                 | \$ 53,471 | \$ 4,412        |

The Corporation considers all overdraft loans to be performing loans given their short-term duration.

**6. DEPOSITS**

Total deposits at September 30, 2012 and December 31, 2011 are summarized as follows (in thousands):

|                                | Percentage<br>Change | September 30, 2012 | December 31, 2011 |
|--------------------------------|----------------------|--------------------|-------------------|
| Checking, non-interest bearing | 10.6%                | \$ 168,888         | \$ 152,732        |
| Checking, interest bearing     | 6.2%                 | 325,072            | 305,960           |
| Savings accounts               | 22.1%                | 765,869            | 627,106           |
| Certificates of deposit        | (17.8%)              | 220,441            | 268,053           |
|                                | 9.3%                 | \$ 1,480,270       | \$ 1,353,851      |





**Table of Contents****7. EARNINGS PER SHARE**

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding during the applicable period, excluding outstanding participating securities. Diluted earnings per share is computed using the weighted average number of shares determined for the basic computation plus the dilutive effect of potential common shares issuable under certain stock compensation plans. For the three and nine months ended September 30, 2012, 37,500 shares issuable pursuant to outstanding stock options under stock compensation plans were excluded from the diluted earnings per share calculations because the strike prices associated with the options exceeded the market price of the Corporation's common stock thus making the shares anti-dilutive. For the three and nine months ended September 30, 2011, 107,375 and 75,500 shares issuable pursuant to outstanding stock options were excluded from the diluted earnings per share calculations because the strike prices associated with the options exceeded the market price of the Corporation's common stock thus making the shares anti-dilutive.

Unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings per share pursuant to the two-class method. The Corporation has determined that its outstanding non-vested stock awards are participating securities.

The computation of basic and diluted earnings per share is shown below (in thousands except share and per share data):

|                                                                                                  | Three months<br>ended<br>September 30, |          | Nine months<br>ended<br>September 30, |           |
|--------------------------------------------------------------------------------------------------|----------------------------------------|----------|---------------------------------------|-----------|
|                                                                                                  | 2012                                   | 2011     | 2012                                  | 2011      |
| Net income per consolidated statements of income                                                 | \$ 4,563                               | \$ 4,067 | \$ 13,246                             | \$ 11,235 |
| Net earnings allocated to participating securities                                               | (17)                                   | (12)     | (50)                                  | (34)      |
| Net earnings allocated to common stock                                                           | \$ 4,546                               | \$ 4,055 | \$ 13,196                             | \$ 11,201 |
| <b>Basic earnings per common share computation:</b>                                              |                                        |          |                                       |           |
| Distributed earnings allocated to common stock                                                   | \$ 2,045                               | \$ 2,025 | \$ 6,130                              | \$ 6,064  |
| Undistributed earnings allocated to common stock                                                 | 2,501                                  | 2,030    | 7,066                                 | 5,137     |
| Net earnings allocated to common stock                                                           | \$ 4,546                               | \$ 4,055 | \$ 13,196                             | \$ 11,201 |
| Weighted average common shares outstanding, including shares considered participating securities | 12,448                                 | 12,315   | 12,430                                | 12,290    |
| Less: Average participating securities                                                           | (41)                                   | (31)     | (42)                                  | (35)      |
| Weighted average shares                                                                          | 12,407                                 | 12,284   | 12,388                                | 12,255    |
| Basic earnings per common share                                                                  | \$ 0.37                                | \$ 0.33  | \$ 1.07                               | \$ 0.91   |
| <b>Diluted earnings per common share computation:</b>                                            |                                        |          |                                       |           |
| Net earnings allocated to common stock                                                           | \$ 4,546                               | \$ 4,055 | \$ 13,196                             | \$ 11,201 |
| Weighted average common shares outstanding for basic earnings per common share                   | 12,407                                 | 12,284   | 12,388                                | 12,255    |
| Add: Dilutive effects of assumed exercises of stock options                                      | 4                                      | 6        | 4                                     | 7         |
| Weighted average shares and dilutive potential common shares                                     | 12,411                                 | 12,290   | 12,392                                | 12,262    |
| Diluted earnings per common share                                                                | \$ 0.37                                | \$ 0.33  | \$ 1.06                               | \$ 0.91   |

**Table of Contents****8. DERIVATIVE INSTRUMENTS**

The Corporation records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges.

For derivatives designated as cash flow hedges, the effective portion of the changes in the fair value of the derivative is initially reported in other comprehensive income (outside of earnings) and subsequently reclassified into earnings when the hedged transaction affects earnings, and the ineffective portion of changes in the fair value of the derivative is recognized directly in earnings. The Corporation assesses the effectiveness of each hedging relationship by comparing the changes in cash flows of the derivative hedging instrument with the changes in cash flows of the designated hedged item or transaction.

On August 1, 2008, the Corporation executed an interest rate swap agreement with a 5 year term and an effective date of September 15, 2008 in order to hedge \$10 million of a subordinated note that was issued by the Corporation during 2007 and elected cash flow hedge accounting for the agreement. The Corporation's objective in using this derivative is to add stability to interest expense and to manage its exposure to interest rate risk. The interest rate swap involves the receipt of variable-rate amounts in exchange for fixed-rate payments from August 1, 2008 to September 15, 2013 without exchange of the underlying notional amount. At September 30, 2012, the variable rate on the subordinated debt was 1.94% (LIBOR plus 155 basis points) and the Corporation was paying 5.84% (4.29% fixed rate plus 155 basis points).

In anticipation of the expiration of the 5 year interest rate swap agreement discussed immediately above, on May 3, 2011, the Corporation executed an interest rate swap agreement with a 5 year term and an effective date of September 15, 2013 which, as of that effective date, will hedge \$10 million of the subordinated note discussed immediately above. As with the prior interest rate swap agreement, the Corporation's objective in using this derivative is to add stability to interest expense and to manage its exposure to interest rate risk. The interest rate swap involves the receipt of variable-rate amounts in exchange for fixed-rate payments from September 15, 2013 to September 15, 2018 without exchange of the underlying notional amount. On the effective date, the variable rate on the subordinated debt will be LIBOR plus 155 basis points and the Corporation will be paying 5.57% (4.02% fixed rate plus 155 basis points).

As of September 30, 2012, no derivatives were designated as fair value hedges or hedges of net investments in foreign operations. Additionally, the Corporation does not use derivatives for trading or speculative purposes and currently does not have any derivatives that are not designated as hedges.

The following tables provide information about the amounts and locations of activity related to the interest rate swaps designated as cash flow hedges within the Corporation's consolidated balance sheet and statement of income as of September 30, 2012 and December 31, 2011 and for the three and nine months ended September 30, 2012 and 2011 (in thousands):

|                          | Balance Sheet Location | Liability Derivative Fair value          |                  |              |     |
|--------------------------|------------------------|------------------------------------------|------------------|--------------|-----|
|                          |                        | September 30, 2012                       | December 31 2011 |              |     |
| As of September 30, 2012 |                        |                                          |                  |              |     |
| Interest rate contracts  | Accrued interest and   |                                          |                  |              |     |
|                          | other liabilities      | (\$ 1,848)                               | (\$ 1,669)       |              |     |
| For the Three Months     |                        |                                          |                  |              |     |
| Ended September 30, 2012 | (a)                    | (b)                                      | (c)              | (d)          | (e) |
| Interest rate contracts  | (\$ 44)                | Interest expense subordinated debentures | (\$ 98)          | Other income | 0   |

**Table of Contents****For the Nine Months****Ended September 30, 2012**

|                         | (a)      | (b)                                         | (c)      | (d)             | (e) |
|-------------------------|----------|---------------------------------------------|----------|-----------------|-----|
| Interest rate contracts | (\$ 116) | Interest expense<br>subordinated debentures | (\$ 290) | Other<br>income | 0   |

**For the Three Months****Ended September 30, 2011**

|                         | (a)      | (b)                                         | (c)      | (d)             | (e)  |
|-------------------------|----------|---------------------------------------------|----------|-----------------|------|
| Interest rate contracts | (\$ 440) | Interest expense<br>subordinated debentures | (\$ 103) | Other<br>income | \$ 0 |

**For the Nine Months****Ended September 30, 2011**

|                         | (a)      | (b)                                         | (c)      | (d)             | (e)  |
|-------------------------|----------|---------------------------------------------|----------|-----------------|------|
| Interest rate contracts | (\$ 519) | Interest expense<br>subordinated debentures | (\$ 303) | Other<br>income | \$ 0 |

- (a) Amount of Gain or (Loss) Recognized in Other Comprehensive Loss on Derivative (Effective Portion), net of tax  
(b) Location of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion)  
(c) Amount of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Loss into Income (Effective Portion)  
(d) Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)  
(e) Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)  
Amounts reported in accumulated other comprehensive loss related to the interest rate swap will be reclassified to interest expense as interest payments are made on the subordinated debentures. Such amounts reclassified from accumulated other comprehensive loss to interest expense in the next twelve months are expected to be \$380.

**9. RECENT ACCOUNTING PRONOUNCEMENTS**

In May 2011, the FASB issued Accounting Standards Update No. 2011-4, Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. Some amendments in this update clarify the FASB's intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The amendments in this update are effective during interim and annual reporting periods beginning after December 15, 2011. The Corporation complied with the revised disclosure requirements.

In June 2011, the FASB issued Accounting Standards Update No. 2011-5, Comprehensive Income (Topic 220), Presentation of Comprehensive Income. This update amends the FASB Accounting Standards Codification (Codification) to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This update eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments to the Codification in this update do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments in this update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and retrospective application is required. The Corporation complied with the revised disclosure requirements.

## **Table of Contents**

In September 2011, the FASB issued Accounting Standards Update No. 2011-08, Intangibles—Goodwill and Other (Topic 350), Testing 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 more-likely-than-not threshold is defined as having a likelihood of more than fifty percent. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The effect of adopting this new guidance did not have a material effect on the Corporation's financial statements.

In December 2011, the FASB issued Accounting Standards Update No. 2011-12, Comprehensive Income (Topic 220): 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. This update defers the specific requirement to present items that are reclassified from accumulated other comprehensive income to net income separately within their respective components of net income and other comprehensive income. As such, the amendments in this update supersede only those paragraphs in Accounting Standards Update No. 2011-05 that pertain to how and where reclassification adjustments are presented. The amendments were effective at the same time as the amendments in Accounting Standards Update 2011-05. The Corporation complied with the revised disclosure requirements.

## **10. SUBSEQUENT EVENT**

In October 2012, an impaired loan classified as commercial, industrial and agricultural was partially repaid, resulting in an additional chargeoff of \$109 and a reduction in nonperforming assets of \$1,800. The allowance for loan losses on this impaired loan at September 30, 2012 was \$101.

## **Table of Contents**

### **ITEM 2**

#### **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION**

#### **AND RESULTS OF OPERATIONS**

The following discussion and analysis of the consolidated financial statements of CNB Financial Corporation (the "Corporation") is presented to provide insight into management's assessment of financial results. The Corporation's principal subsidiary, CNB Bank (the "Bank"), provides financial services to individuals and businesses primarily within the Pennsylvania counties of Cambria, Cameron, Clearfield, Elk, Indiana, and McKean. It also includes a portion of western Centre County including Philipsburg Borough, Rush Township and the western portions of Snow Shoe and Burnside Townships and a portion of Jefferson County, consisting of the boroughs of Brockway, Falls Creek, Punxsutawney, Reynoldsville and Sykesville, and the townships of Washington, Winslow and Henderson. ERIEBANK, a division of CNB Bank, provides financial services to individuals and businesses in the northwestern Pennsylvania counties of Erie, Crawford, and Warren.

The Bank is subject to regulation, supervision and examination by the Pennsylvania State Department of Banking as well as the Federal Deposit Insurance Corporation. The financial condition and results of operations of the Corporation and its consolidated subsidiaries are not necessarily indicative of future performance. CNB Securities Corporation is incorporated in Delaware and currently maintains investments in debt and equity securities. County Reinsurance Company is an Arizona Corporation, and provides credit life and disability insurance for customers of CNB Bank. CNB Insurance Agency, incorporated in Pennsylvania, provides for the sale of nonproprietary annuities and other insurance products. Holiday Financial Services Corporation, incorporated in Pennsylvania, offers small balance unsecured loans and secured loans, primarily collateralized by automobiles and equipment, to borrowers with higher risk characteristics. When we use the terms "we", "us" and "our", we mean CNB Financial Corporation and its subsidiaries. Management's discussion and analysis should be read in conjunction with the Corporation's consolidated financial statements and related notes.

#### **GENERAL OVERVIEW**

The Bank expanded its ERIEBANK division by opening a second full service office in Meadville, Pennsylvania in the third quarter of 2012. In addition, a CNB Bank loan production office was opened in Indiana, Pennsylvania in the third quarter of 2011. A CNB Bank loan production office in Johnstown, Pennsylvania was closed in the third quarter of 2011. The Corporation also opened a ninth office for Holiday Financial Services Corporation in Dubois, Pennsylvania in the third quarter of 2012. The Corporation also purchased a consumer discount company in Ebensburg, Pennsylvania during the third quarter of 2012, resulting in the acquisition of a loan portfolio of approximately \$1 million with a purchase premium of \$200 thousand. The Corporation is operating the acquired location as its tenth Holiday Financial Services Corporation office.

Management believes that the Corporation's ERIEBANK market, along with the traditional CNB Bank and Holiday Financial Services Corporation market areas, should provide the Bank with sustained loan and deposit growth during the remainder of 2012. Loan growth and deposit growth were \$60 million and \$126 million, respectively, during the nine months ended September 30, 2012.

Management concentrates on return on average equity and earnings per share metrics, plus other metrics, to measure the performance of the Corporation. The interest rate environment will continue to play an important role in the future earnings of the Corporation. Some compression of the net interest margin was experienced in 2011 and the net interest margin has decreased 10 basis points in the first nine months of 2012 compared to the first nine months of 2011 as a result of the current interest rate environment. During the past several years, in order to address the historic lows on various key interest rates such as the Prime Rate and 3-month LIBOR, the Corporation has taken a variety of measures including instituting rate floors on our commercial lines of credit and home equity lines. In addition, the Corporation decreased interest rates on certain deposit products during 2011 and the first nine months of 2012 but maintained deposit growth in 2012 as a result of marketing a savings product which carries a highly competitive annual percentage yield. Non-interest costs are expected to increase with the growth of the Corporation; however, management's growth strategies are expected to also result in an increase in earning assets as well as enhanced non-interest income which is expected to more than offset increases in non-interest expenses in 2012 and beyond. While past results are not an indication of future earnings, management believes the Corporation is well-positioned to sustain core earnings during 2012.

## **Table of Contents**

On July 21, 2010, the Dodd-Frank Wall Street and Consumer Protection Act (the "Dodd-Frank Act") was enacted and this law could impact the performance of the Corporation in future periods. The Dodd-Frank Act includes numerous provisions designed to strengthen the financial industry, enhance consumer protection, expand disclosures and provide for transparency. Some of these provisions included changes to FDIC insurance coverage, which has now been increased to \$250,000. Additional provisions created a Consumer Financial Protection Bureau, which is authorized to write rules on all consumer financial products, and a Financial Services Oversight Council, which is empowered to determine which entities are systematically significant and require tougher regulations and is charged with reviewing, and when appropriate, submitting comments to the Securities and Exchange Commission and Financial Accounting Standards Board with respect to existing or proposed accounting principles, standards or procedures. Although the aforementioned provisions are only a few of the numerous ones included in the Dodd-Frank Act, the full impact of the entire Dodd-Frank Act will not be known until the full implementation is completed. Management will have to apply resources to ensure compliance with all applicable provisions of the Dodd-Frank Act and any implantation rules, which may increase our costs of operations and adversely affect our earnings.

## **CASH AND CASH EQUIVALENTS**

Cash and cash equivalents totaled \$32.9 million at September 30, 2012 compared to \$39.7 million at December 31, 2011. Cash and cash equivalents fluctuate based on the timing and amount of liquidity events that occur in the normal course of business.

Management believes the liquidity needs of the Corporation are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, and the portion of the investment and loan portfolios that mature within one year. These sources of funds will enable the Corporation to meet cash obligations and off-balance sheet commitments as they come due.

## **SECURITIES**

Securities available for sale and trading securities have combined to increase \$81.6 million or 12.7% since December 31, 2011. The increase is primarily due to the purchases of residential mortgage and asset backed securities issued by government sponsored entities and resulted from deposit growth not reinvested in loans. See the notes to the consolidated financial statements for additional detail concerning the composition of the Corporation's securities portfolio and the process for evaluating securities for other-than-temporary impairment.

The Corporation generally buys into the market over time and does not attempt to "time" its transactions. In doing this, the highs and lows of the market are averaged into the portfolio and minimize the overall effect of different rate environments. Management monitors the earnings performance and the effectiveness of the liquidity of the securities portfolio on a regular basis through meetings of the Asset/Liability Committee of the Corporation's Board of Directors ("ALCO"). The ALCO also reviews and manages interest rate risk for the Corporation. Through active balance sheet management and analysis of the securities portfolio, a sufficient level of liquidity is maintained to satisfy depositor requirements and various credit needs of our customers.

## **LOANS**

The Corporation experienced an increase in loans, net of unearned discount, of \$60.3 million, or 7.1%, during the first nine months of 2012. Lending efforts are focused in the west, central and northwest Pennsylvania markets and consist principally of commercial and retail lending, which includes single family residential mortgages and other consumer loans. The Corporation views commercial lending as its competitive advantage and continues to focus on this area by hiring and retaining experienced loan officers and supporting them with quality credit analysis. The Corporation expects sustained loan demand throughout the remainder of 2012.

## **ALLOWANCE FOR LOAN LOSSES**

The allowance for loan losses is established by provisions for losses in the loan portfolio as well as overdrafts in deposit accounts. These provisions are charged against current income. Loans and overdrafts deemed not collectible are charged off against the allowance while any subsequent collections are recorded as recoveries and increase the allowance.

## Table of Contents

The table below shows activity within the allowance account for the specified periods (in thousands):

|                                               | Nine months ending<br>September 30,<br>2012 | Year ending<br>December 31, 2011 | Nine months ending<br>September 30,<br>2011 |
|-----------------------------------------------|---------------------------------------------|----------------------------------|---------------------------------------------|
| Balance at beginning of period                | \$ 12,615                                   | \$ 10,820                        | \$ 10,820                                   |
| Charge-offs:                                  |                                             |                                  |                                             |
| Commercial, industrial, and agricultural      | 1,398                                       | 1,796                            | 299                                         |
| Commercial mortgages                          | 401                                         | 175                              | 100                                         |
| Residential real estate                       | 231                                         | 217                              | 132                                         |
| Consumer                                      | 890                                         | 907                              | 683                                         |
| Credit cards                                  | 55                                          | 39                               | 37                                          |
| Overdrafts                                    | 197                                         | 222                              | 165                                         |
|                                               | 3,172                                       | 3,356                            | 1,416                                       |
| Recoveries:                                   |                                             |                                  |                                             |
| Commercial, industrial, and agricultural      | 14                                          | 9                                | 7                                           |
| Commercial mortgages                          |                                             |                                  |                                             |
| Residential real estate                       | 1                                           | 13                               | 12                                          |
| Consumer                                      | 67                                          | 88                               | 76                                          |
| Credit cards                                  | 8                                           | 10                               | 8                                           |
| Overdraft deposit accounts                    | 78                                          | 94                               | 72                                          |
|                                               | 168                                         | 214                              | 175                                         |
| Net charge-offs                               | (3,004)                                     | (3,142)                          | (1,241)                                     |
| Provision for loan losses                     | 4,038                                       | 4,937                            | 2,673                                       |
| Balance at end of period                      | \$ 13,649                                   | \$ 12,615                        | \$ 12,252                                   |
| Loans, net of unearned                        | \$ 910,217                                  | \$ 849,883                       | \$ 835,666                                  |
| Allowance to net loans                        | 1.50%                                       | 1.48%                            | 1.47%                                       |
| Net charge-offs to average loans (annualized) | 0.45%                                       | 0.38%                            | 0.20%                                       |
| Nonperforming assets                          | \$ 19,502                                   | \$ 17,513                        | \$ 19,463                                   |
| Nonperforming % of total assets               | 1.12%                                       | 1.09%                            | 1.26%                                       |

The adequacy of the allowance for loan losses is subject to a formal analysis by the credit administrator of the Corporation. As part of the formal analysis, delinquencies and losses are monitored monthly. The loan portfolio is divided into several categories in order to better analyze the entire pool. First is a selection of classified loans that is given a specific reserve. The remaining loans are pooled, by category, into these segments:

### Reviewed

Commercial, industrial, and agricultural

Commercial mortgages

### Homogeneous

Residential real estate

Consumer

Credit cards

Overdrafts

The reviewed loan pools are further segregated into four categories: special mention, substandard, doubtful, and unclassified. Historical loss factors are calculated for each pool excluding overdrafts based on the previous eight quarters of experience. The homogeneous pools are evaluated by analyzing the historical loss factors from the most previous quarter end and the two most recent year ends.



## **Table of Contents**

The historical loss factors for both the reviewed and homogeneous pools are adjusted based on these six qualitative factors:

levels of and trends in delinquencies, non-accrual loans, and classified loans;

trends in volume and terms of loans;

effects of any changes in lending policies and procedures;

experience, ability and depth of management;

national and local economic trends and conditions; and

concentrations of credit.

The methodology described above was created using the experience of the Corporation's credit administrator, guidance from the regulatory agencies, expertise of a third-party loan review provider, and discussions with peers. The resulting factors are applied to the pool balances in order to estimate the probable risk of loss within each pool. Prudent business practices dictate that the level of the allowance, as well as corresponding charges to the provision for loan losses, should be commensurate with identified areas of risk within the loan portfolio and the attendant risks inherent therein. The quality of the credit risk management function and the overall administration of this vital segment of the Corporation's assets are critical to the ongoing success of the Corporation.

The previously mentioned analysis considered numerous historical and other factors to analyze the adequacy of the allowance and current period charges against the provision for loan losses. Management paid special attention to a section of the analysis that compared and plotted the actual level of the allowance against the aggregate amount of loans adversely classified in order to compute the estimated probable losses associated with those loans. By noting the spread at the present time, as well as prior periods, management determines the current adequacy of the allowance as well as evaluates trends that may be developing. The volume and composition of the Corporation's loan portfolio continue to reflect growth in commercial credits including commercial real estate loans.

As mentioned in the Loans section of this analysis, management considers commercial lending to be a competitive advantage and continues to focus on this area as part of its strategic growth initiatives. However, management recognizes and considers the fact that risk is more pronounced in these types of credits and is, to a greater degree than with other loans, driven by the economic environment in which the debtor's business operates.

During the nine months ended September 30, 2012, the Corporation recorded a provision for loan losses of \$4.0 million, as compared to a provision for loan losses of \$2.7 million for the nine months ended September 30, 2011. The increase was a result of increases in loss reserves, primarily in the commercial loan portfolio. One relationship comprising two commercial loans which became impaired in 2011 necessitated an additional loss reserve of \$360 thousand in the first quarter of 2012 as a result of the revision in the valuation estimate of the loan collateral. Charge-offs attributable to this loan relationship totaled \$600 thousand during the nine months ended September 30, 2012.

In May 2012, CNB management determined that one relationship comprising a commercial loan of \$2.4 million and two consumer loans totaling \$200 thousand had become impaired. CNB charged off the balances of the consumer loans and recorded a specific allocation of \$1.1 million for the commercial loan based on CNB's evaluation of the borrowers' ability and willingness to repay the loan. As a result, the provision for loan losses increased by \$1.3 million during the nine months ended September 30, 2012. CNB charged off \$750 thousand related to the commercial loan in the third quarter of 2012. In September 2012, one relationship comprising two commercial mortgage loans totaling \$1.7 million that had previously been modified in a troubled debt restructuring defaulted under its restructured terms, resulting in an increase in the provision for loan losses during the three and nine months ended September 30, 2012 of \$503 thousand. It is possible that further deterioration with respect to these loan relationships may occur in the future.

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Management believes that the allowance for loan losses is reasonable and adequate to absorb probable incurred losses in its portfolio at September 30, 2012.

### **FUNDING SOURCES**

The Corporation considers deposits, short-term borrowings, and term debt when evaluating funding sources. Traditional deposits continue to be the main source of funds in the Corporation, increasing \$126.4 million from \$1.35 billion at December 31, 2011 to \$1.48 billion at September 30, 2012. The growth in deposits was primarily due to increases in savings

**Table of Contents**

accounts of \$138.8 million over this period as a result of the Corporation's marketing of a savings product which carries an annual percentage yield which is highly competitive in the current interest rate environment. This increase in savings accounts was offset by an expected decrease in time deposits of \$47.6 million as customers who previously held certificates of deposit migrated to the savings product.

Periodically, the Corporation utilizes term borrowings from the Federal Home Loan Bank ( FHLB ) and other lenders to meet funding needs. Management plans to maintain access to short-term and long-term borrowings as an available funding source.

**SHAREHOLDERS' EQUITY AND CAPITAL RATIOS AND METRICS**

The Corporation's capital continued to provide a base for profitable growth through September 30, 2012. Total shareholders' equity was \$143.7 million at September 30, 2012 and \$131.9 million at December 31, 2011. In the first nine months of 2012, the Corporation earned \$13.2 million and declared dividends of \$6.2 million, a dividend payout ratio of 46.5% of net income. The Corporation has also complied with the standards of capital adequacy mandated by the banking regulators. Bank regulators have established risk-based capital requirements designed to measure capital adequacy. Risk-based capital ratios reflect the relative risks of various assets banks hold in their portfolios. A weight category of 0% (lowest risk assets), 20%, 50%, or 100% (highest risk assets) is assigned to each asset on the balance sheet.

The Corporation's capital ratios, book value per share and tangible book value per share as of September 30, 2012 and December 31, 2011 are as follows:

|                                            | September 30, 2012 | December 31, 2011 |
|--------------------------------------------|--------------------|-------------------|
| Total risk-based capital ratio             | 15.36%             | 15.14%            |
| Tier 1 capital ratio                       | 14.10%             | 13.89%            |
| Leverage ratio                             | 8.03%              | 8.22%             |
| Tangible common equity/tangible assets (1) | 7.67%              | 7.61%             |
| Book value per share                       | \$ 11.52           | \$ 10.66          |
| Tangible book value per share (1)          | 10.64              | 9.78              |

- (1) Tangible common equity, tangible assets and tangible book value per share are non-GAAP financial measures calculated using GAAP amounts. Tangible common equity is calculated by excluding the balance of goodwill from the calculation of shareholders' equity. Tangible assets is calculated by excluding the balance of goodwill from the calculation of total assets. Tangible book value per share is calculated by dividing tangible common equity by the number of shares outstanding. The Corporation believes that these non-GAAP financial measures provide information to investors that is useful in understanding its financial condition because they are additional measures used to assess capital adequacy. Because not all companies use the same calculation of tangible common equity and tangible assets, this presentation may not be comparable to other similarly titled measures calculated by other companies. A reconciliation of these non-GAAP financial measures is provided below (dollars in thousands, except share and per share data).

|                                        | September 30, 2012 | December 31, 2011 |
|----------------------------------------|--------------------|-------------------|
| Shareholders' equity                   | \$ 143,691         | \$ 131,889        |
| Less goodwill                          | 10,946             | 10,821            |
| Tangible common equity                 | \$ 132,745         | \$ 121,068        |
| Total assets                           | \$ 1,741,197       | \$ 1,602,207      |
| Less goodwill                          | 10,946             | 10,821            |
| Tangible assets                        | \$ 1,730,251       | \$ 1,591,386      |
| Ending shares outstanding              | 12,470,371         | 12,377,318        |
| Tangible book value per share          | \$ 10.64           | \$ 9.78           |
| Tangible common equity/tangible assets | 7.67%              | 7.61%             |



## **Table of Contents**

### **LIQUIDITY**

Liquidity measures an organization's ability to meet cash obligations as they come due. The consolidated statement of cash flows provides analysis of the Corporation's cash and cash equivalents. Additionally, management considers that portion of the loan and investment portfolio that matures within one year to be part of the Corporation's liquid assets. The Corporation's liquidity is monitored by both management and the ALCO, which establishes and monitors ranges of acceptable liquidity. Management believes the Corporation's current liquidity position is acceptable.

### **OFF BALANCE SHEET ACTIVITIES**

Some financial instruments, such as loan commitments, credit lines, letters of credit and overdraft protection, are issued to meet customer financing needs. The contractual amount of financial instruments with off-balance sheet risk was as follows at September 30, 2012 (in thousands):

|                              |                   |
|------------------------------|-------------------|
| Commitments to extend credit | \$ 241,436        |
| Standby letters of credit    | 22,135            |
|                              | <b>\$ 263,571</b> |

**Table of Contents**

## CONSOLIDATED YIELD COMPARISONS

## AVERAGE BALANCES AND NET INTEREST MARGIN FOR THE NINE MONTHS ENDED

Dollars in thousands

|                                             | September 30, 2012 |             |                    | September 30, 2011 |             |                    |
|---------------------------------------------|--------------------|-------------|--------------------|--------------------|-------------|--------------------|
|                                             | Average Balance    | Annual Rate | Interest Inc./Exp. | Average Balance    | Annual Rate | Interest Inc./Exp. |
| <b>ASSETS:</b>                              |                    |             |                    |                    |             |                    |
| Interest-bearing deposits with other banks  | \$ 3,934           | 0.01%       | \$                 | \$ 14,018          | 0.97%       | \$ 102             |
| <b>Securities:</b>                          |                    |             |                    |                    |             |                    |
| Taxable (1)                                 | 601,280            | 2.56%       | 11,226             | 471,726            | 3.03%       | 10,640             |
| Tax-Exempt (1,2)                            | 112,936            | 4.96%       | 3,971              | 82,340             | 5.22%       | 3,138              |
| Equity Securities (1,2)                     | 2,710              | 3.10%       | 63                 | 1,723              | 2.42%       | 31                 |
| Total securities                            | 716,926            | 2.93%       | 15,260             | 555,789            | 3.35%       | 13,809             |
| <b>Loans:</b>                               |                    |             |                    |                    |             |                    |
| Commercial (2)                              | 296,040            | 4.98%       | 11,050             | 276,786            | 5.20%       | 10,793             |
| Mortgage (2)                                | 539,087            | 5.36%       | 21,679             | 484,936            | 5.72%       | 20,816             |
| Consumer                                    | 49,819             | 13.11%      | 4,897              | 50,011             | 12.86%      | 4,822              |
| Total loans (3)                             | 884,946            | 5.67%       | 37,626             | 811,733            | 5.98%       | 36,431             |
| Total earning assets                        | 1,605,806          | 4.45%       | \$ 52,886          | 1,381,540          | 4.88%       | \$ 50,342          |
| <b>Non interest-bearing assets:</b>         |                    |             |                    |                    |             |                    |
| Cash and due from banks                     | 28,525             |             |                    | 33,570             |             |                    |
| Premises and equipment                      | 24,088             |             |                    | 24,405             |             |                    |
| Other assets                                | 55,679             |             |                    | 57,111             |             |                    |
| Allowance for loan losses                   | (13,252)           |             |                    | (11,570)           |             |                    |
| Total non interest-bearing assets           | 95,040             |             |                    | 103,516            |             |                    |
| TOTAL ASSETS                                | \$ 1,700,846       |             |                    | \$ 1,485,056       |             |                    |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY:</b> |                    |             |                    |                    |             |                    |
| Demand - interest-bearing                   | \$ 306,317         | 0.51%       | 1,176              | \$ 294,054         | 0.80%       | 1,761              |
| Savings                                     | 730,731            | 0.81%       | 4,421              | 465,215            | 1.14%       | 3,971              |
| Time                                        | 234,139            | 1.66%       | 2,922              | 335,701            | 1.84%       | 4,628              |
| Total interest-bearing deposits             | 1,271,187          | 0.89%       | 8,519              | 1,094,970          | 1.26%       | 10,360             |
| Short-term borrowings                       | 9,924              | 0.16%       | 12                 | 12,671             | 0.28%       | 27                 |
| Long-term borrowings                        | 74,390             | 4.31%       | 2,406              | 74,032             | 4.23%       | 2,346              |
| Subordinated debentures                     | 20,620             | 3.92%       | 606                | 20,620             | 3.76%       | 582                |
| Total interest-bearing liabilities          | 1,376,121          | 1.12%       | \$ 11,543          | 1,202,293          | 1.48%       | \$ 13,315          |
| Demand - non interest-bearing               | 162,898            |             |                    | 147,193            |             |                    |
| Other liabilities                           | 22,791             |             |                    | 16,116             |             |                    |

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|                                                   |                     |                  |                     |                  |
|---------------------------------------------------|---------------------|------------------|---------------------|------------------|
| Total liabilities                                 | 1,561,810           |                  | 1,365,602           |                  |
| Shareholders' equity                              | 139,036             |                  | 119,454             |                  |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> | <b>\$ 1,700,846</b> |                  | <b>\$ 1,485,056</b> |                  |
| Interest income/Earning assets                    | 4.45%               | \$ 52,886        | 4.88%               | \$ 50,342        |
| Interest expense/Interest-bearing liabilities     | 1.12%               | 11,543           | 1.48%               | 13,315           |
| <b>Net interest spread</b>                        | <b>3.33%</b>        | <b>\$ 41,343</b> | <b>3.40%</b>        | <b>\$ 37,027</b> |
| Interest income/Earning assets                    | 4.45%               | 52,886           | 4.88%               | 50,342           |
| Interest expense/Earning assets                   | 0.96%               | 11,543           | 1.29%               | 13,315           |
| <b>Net interest margin</b>                        | <b>3.49%</b>        | <b>\$ 41,343</b> | <b>3.59%</b>        | <b>\$ 37,027</b> |

- (1) Includes unamortized discounts and premiums. Average balance is computed using the carrying value of securities. The average yield has been computed using the historical amortized cost average balance for available for sale securities.
- (2) Average yields are stated on a fully taxable equivalent basis.
- (3) Average outstanding includes the average balance outstanding of all non-accrual loans. Loans consist of the average of total loans less average unearned income. The amount of loan fees included in the interest income on loans is not material.

## **Table of Contents**

### **RESULTS OF OPERATIONS**

#### **Three Months Ended September 30, 2012 and 2011**

#### **OVERVIEW OF THE INCOME STATEMENT**

The Corporation had net income of \$4.6 million in the third quarter of 2012 compared to \$4.1 million for the same period of 2011. The earnings per diluted share were \$0.37 in the third quarter of 2012 and \$0.33 in the third quarter of 2011.

#### **INTEREST INCOME AND EXPENSE**

Net interest income totaled \$13.7 million, an increase of \$1.3 million, or 10.4%, over the third quarter of 2011. Total interest and dividend income increased by \$340 thousand, or 2.0%, as compared to the third quarter of 2011. Although the Corporation's earning assets continue to grow, these increases have been offset by decreases in the yield on earning assets, primarily because the composition of earning assets has shifted to a greater percentage of investment securities as deposit growth has exceeded loan growth. Total interest expense decreased \$952 thousand, or 21.6%, as compared to the third quarter of 2011 due to decreases in the cost of core deposits.

#### **PROVISION FOR LOAN LOSSES**

The Corporation recorded a provision for loan losses of \$1.2 million in the third quarter of 2012 compared to \$904 thousand in the third quarter of 2011. As disclosed in the Allowance for Loan Losses section of Management's Discussion and Analysis, the Corporation increased its loan loss reserves in the commercial mortgage loan portfolio during the third quarter of 2012.

Management believes the provision for loan losses was appropriate and the allowance for loan losses is adequate to absorb probable incurred losses in our portfolio as of September 30, 2012.

#### **NON-INTEREST INCOME**

Excluding the effects of the securities transactions described below, non-interest income was \$2.7 million for both the three months ended September 30, 2012 and the three months ended September 30, 2011. Net realized gains on available-for-sale securities were \$103 thousand during the three months ended September 30, 2012, and \$84 thousand during the three months ended September 30, 2011. Net realized and unrealized gains (losses) on securities for which fair value accounting was elected were \$275 thousand and (\$313) thousand during the three months ended September 30, 2012 and 2011, respectively.

#### **NON-INTEREST EXPENSES**

Total non-interest expenses increased \$898 thousand, or 10.8%, during the three months ended September 30, 2012 compared to the three months ended September 30, 2011. Salaries and benefits expenses increased \$429 thousand, or 9.7%, during the three months ended September 30, 2012 compared to the three months ended September 30, 2011, in part due to routine merit increases, an increase in average full-time equivalent employees, and increases in certain employee benefit expenses, such as health insurance costs, which continue to increase in line with market conditions.

Total non-interest expenses on an annualized basis in relation to CNB's average asset size declined from 2.18% for the three months ended September 30, 2011 to 2.12% for the three months ended September 30, 2012.

#### **INCOME TAX EXPENSE**

Income tax expense was \$1.8 million in the third quarter of 2012 as compared to \$1.6 million in the third quarter of 2011, resulting in effective tax rates of 28.2% and 27.7% for the periods, respectively. The effective rates for the periods differed from the federal statutory rate of 35.0% principally as a result of tax exempt income from securities and loans as well as earnings from bank owned life insurance.



## **Table of Contents**

### **Nine Months Ended September 30, 2012 and 2011**

#### **OVERVIEW OF THE INCOME STATEMENT**

The Corporation had net income of \$13.2 million for the nine months ended September 30, 2012 compared to \$11.2 million for the same period of 2011. The earnings per diluted share was \$1.06 for the nine months ended September 30, 2012 and \$0.91 for the nine months ended September 30, 2011. The return on assets and return on equity for the nine months ended September 30, 2012 are 1.04% and 12.70%, respectively, compared to 1.01% and 12.54%, respectively, for the same period of 2011.

#### **INTEREST INCOME AND EXPENSE**

During the nine months ended September 30, 2012, net interest income increased \$4.0 million, or 11.3%, compared to the comparable period in 2011. The Corporation's net interest margin on a fully tax equivalent basis was 3.49% for the nine months ended September 30, 2012, compared to 3.59% for the comparable period in 2011.

Although the Corporation's earning assets continue to grow, these increases have been offset by decreases in the yield on earning assets, primarily because the composition of earning assets has shifted to a greater percentage of investment securities as deposit growth has exceeded loan growth. During the nine months ended September 30, 2012, total interest expense decreased \$1.8 million, or 13.3%, as compared to the comparable period in 2011 due to decreases in the cost of core deposits.

#### **PROVISION FOR LOAN LOSSES**

The Corporation recorded a provision for loan losses of \$4.0 million during the nine months ended September 30, 2012 compared to \$2.7 million for the comparable period of 2011. As disclosed in the Allowance for Loan Losses section of Management's Discussion and Analysis, the Corporation increased its loan loss reserves in the commercial and commercial mortgage loan portfolios during the first nine months of 2012. In addition, total net loan chargeoffs were \$3.0 million in the first nine months of 2012 compared to \$1.2 million for the comparable period of 2011.

Management believes the provision for loan losses was appropriate and the allowance for loan losses is adequate to absorb probable incurred losses in our portfolio as of September 30, 2012.

#### **NON-INTEREST INCOME**

Excluding the effects of the securities transactions described below, non-interest income was \$7.9 million for the nine months ended September 30, 2012, compared to \$7.7 million for the nine months ended September 30, 2011. Net realized gains on available-for-sale securities were \$1.4 million during the nine months ended September 30, 2012, compared to \$158 thousand during the nine months ended September 30, 2011. Net realized and unrealized gains (losses) on securities for which fair value was elected were \$455 thousand and (\$216) thousand during the nine months ended September 30, 2012 and 2011, respectively. An other-than-temporary impairment charge of \$398 thousand was recorded in earnings on structured pooled trust preferred securities during the nine months ended September 30, 2011.

#### **NON-INTEREST EXPENSES**

Total non-interest expenses increased \$2.3 million, or 9.3%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. Salaries and benefits expenses increased \$1.3 million, or 10.4%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, in part due to routine merit increases, an increase in average full-time equivalent employees, and increases in certain employee benefit expenses, such as health insurance costs, which continue to increase in line with market conditions. In addition, other non-interest expenses increased from \$7.6 million for the nine months ended September 30, 2011 to \$8.7 million for the nine months ended September 30, 2012 as a result of CNB's continued growth.

## **Table of Contents**

Total non-interest expenses on an annualized basis in relation to CNB's average asset size declined from 2.22% for the nine months ended September 30, 2011 to 2.12% for the nine months ended September 30, 2012.

### **INCOME TAX EXPENSE**

Income tax expense was \$5.0 million for the nine months ended September 30, 2012 as compared to \$4.2 million for the nine months ended September 30, 2011, resulting in effective tax rates of 27.6% and 27.2% for the periods, respectively. The effective rates for the periods differed from the federal statutory rate of 35.0% principally as a result of tax exempt income from securities and loans as well as earnings from bank owned life insurance.

### **CRITICAL ACCOUNTING POLICIES**

The Corporation's accounting and reporting policies are in accordance with GAAP and conform to general practices within the financial services industry. Accounting and reporting practices for the allowance for loan losses and fair value of securities are deemed critical since they involve the use of estimates and require significant management judgments. Application of assumptions different than those used by management could result in material changes in the Corporation's financial position or results of operations. Note 1 (Summary of Significant Accounting Policies), Note 3 (Securities), and Note 4 (Loans), of the Corporation's 2011 Form 10-K, provide detail with regard to the Corporation's accounting for the allowance for loan losses and fair value of securities. There have been no significant changes in the application of accounting policies since December 31, 2011.

### **ITEM 3**

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a financial institution, the Corporation's primary source of market risk is interest rate risk, which is the exposure to fluctuations in the Corporation's future earnings resulting from changes in interest rates. This exposure is correlated to the repricing characteristics of the Corporation's portfolio of assets and liabilities. Each asset or liability reprices either at maturity or during the life of the instrument.

The principal purpose of asset/liability management is to maximize current and future net interest income within acceptable levels of interest rate risk while satisfying liquidity and capital requirements. Net interest income is enhanced by increasing the net interest margin and by the growth in earning assets. As a result, the primary goal of interest rate risk management is to maintain a balance between risk and reward such that net interest income is maximized while risk is maintained at an acceptable level.

The Corporation uses an asset-liability management model to measure the effect of interest rate changes on its net interest income. The Corporation's management also reviews asset-liability maturity gap and repricing analyses regularly. The Corporation does not always attempt to achieve a precise match between interest sensitive assets and liabilities because it believes that an actively managed amount of interest rate risk is inherent and appropriate in the management of the Corporation's profitability.

Asset-liability modeling techniques and simulation involve assumptions and estimates that inherently cannot be measured with precision. Key assumptions in these analyses include maturity and repricing characteristics of assets and liabilities, prepayments on amortizing assets, non-maturing deposit sensitivity, and loan and deposit pricing. These assumptions are inherently uncertain due to the timing, magnitude, and frequency of rate changes and changes in market conditions and management strategies, among other factors. However, the analyses are useful in quantifying risk and provide a relative gauge of the Corporation's interest rate risk position over time.

Management reviews interest rate risk on a quarterly basis and reports to the ALCO. This review includes earnings shock scenarios whereby interest rates are immediately increased and decreased by 100, 300, and 400 basis points. These scenarios, detailed in the table below, indicate that there would not be a significant variance in net interest income over a one-year period due to interest rate changes; however, actual results could vary significantly. At September 30, 2012 and December 31, 2011, all interest rate risk levels according to the model were within the tolerance limits of ALCO approved policy of +/- 25%.

## Table of Contents

In addition, the table does not take into consideration changes that management would make to realign its assets and liabilities in the event of an unexpected changing interest rate environment. Due to the historically low interest rate environment, the -300 and -400 scenarios have been excluded from the table.

| September 30, 2012 |                 | December 31, 2011 |                 |
|--------------------|-----------------|-------------------|-----------------|
| Change in          | % Change in Net | Change in         | % Change in Net |
| Basis Points       | Interest Income | Basis Points      | Interest Income |
| 400                | -1.7%           | 400               | -2.3%           |
| 300                | 2.5%            | 300               | -0.1%           |
| 100                | 1.9%            | 100               | 1.5%            |
| (100)              | 0.5%            | (100)             | -5.5%           |

## ITEM 4

## CONTROLS AND PROCEDURES

As of the end of the period covered by this quarterly report, an evaluation was carried out under the supervision and with the participation of the Corporation's management, including the Chief Executive Officer and Principal Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934) (Exchange Act). Based on their evaluation, our Chief Executive Officer and Principal Financial Officer have concluded that the Corporation's disclosure controls and procedures were effective as of the end of the period covered by this quarterly report to ensure that information required to be disclosed by the Corporation in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. There were no changes in the Corporation's internal control over financial reporting that occurred during the period covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

ITEM 1. LEGAL PROCEEDINGS None

ITEM 1A. RISK FACTORS There have been no material changes to the risk factors disclosed in Part I, Item 1A. of the 2011 Form 10-K.

ITEM 6. EXHIBITS

Exhibit

| No.  | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1  | Amended and Restated Articles of Incorporation of the Corporation, filed as Appendix B to the 2005 Proxy Statement, filed with the SEC on March 24, 2006, and incorporated herein by reference.                                                                                                                                                                                                                                                                                                  |
| 3.2  | By-Laws of the Corporation, as amended and restated, filed as Appendix C to the 2005 Proxy Statement, filed with the SEC on March 24, 2006, and incorporated herein by reference.                                                                                                                                                                                                                                                                                                                |
| 31.1 | Rule 13a 14(a)/15d 14(a) Certification of the Principal Executive Officer                                                                                                                                                                                                                                                                                                                                                                                                                        |
| 31.2 | Rule 13a 14(a)/15d 14(a) Certification of the Principal Financial Officer                                                                                                                                                                                                                                                                                                                                                                                                                        |
| 32.1 | Section 1350 Certification                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| 32.2 | Section 1350 Certification                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| 101  | The following financial information from the Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, furnished electronically herewith, and formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Comprehensive Income; (iv) Consolidated Statements of Cash Flows; and (v) Notes to Consolidated Financial Statements, tagged as blocks of text.* |

\* In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CNB FINANCIAL CORPORATION  
(Registrant)

DATE: November 8, 2012

/s/ Joseph B. Bower, Jr.  
Joseph B. Bower, Jr.  
President and Director  
(Principal Executive Officer)

DATE: November 8, 2012

/s/ Brian W. Wingard  
Brian W. Wingard  
Treasurer  
(Principal Financial Officer)

**Table of Contents**

EXHIBIT INDEX

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