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First Bancorp, Inc /ME/

Form 10-Q

November 09, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934

For the quarterly period ended September 30, 2012

Commission File Number 0-26589

THE FIRST BANCORP, INC.

(Exact name of Registrant as specified in its charter)

MAINE

(State or other jurisdiction of incorporation or organization)

01-0404322

(I.R.S. Employer Identification No.)

MAIN STREET, DAMARISCOTTA, MAINE 04543

(Address of principal executive offices) (Zip code)

(207) 563-3195

Registrant's telephone number, including area code

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 (§232.405 of this chapter) 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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes  No

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of November 1, 2012  
Common Stock: 9,853,396 shares

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|---|-----------|
| <u>Table of Contents</u>  |           |
| <u>Part I. Financial Information</u>  | <u>1</u>  |
| <u>Selected Financial Data (Unaudited)</u>  | <u>1</u>  |
| <u>Item 1 – Financial Statements</u>  | <u>2</u>  |
| <u>Report of Independent Registered Public Accounting Firm</u>  | <u>2</u>  |
| <u>Consolidated Balance Sheets (Unaudited)</u>  | <u>3</u>  |
| <u>Consolidated Statements of Income and Comprehensive Income (Unaudited)</u>                         | <u>4</u>  |
| <u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited)</u>                         | <u>5</u>  |
| <u>Consolidated Statements of Cash Flows (Unaudited)</u>  | <u>6</u>  |
| <u>Notes to Consolidated Financial Statements</u>   | <u>7</u>  |
| <u>Note 1 – Basis of Presentation</u>   | <u>7</u>  |
| <u>Note 2 –Investment Securities</u>  | <u>7</u>  |
| <u>Note 3 – Loans</u>   | <u>11</u> |
| <u>Note 4 – Allowance for Loan Losses</u>   | <u>17</u> |
| <u>Note 5 – Stock Options and Stock Based Compensation</u>  | <u>25</u> |
| <u>Note 6 – Preferred and Common Stock</u>  | <u>26</u> |
| <u>Note 7 – Earnings Per Share</u>  | <u>27</u> |
| <u>Note 8 – Employee Benefit Plans</u>  | <u>28</u> |
| <u>Note 9 – Goodwill and Other Intangible Assets</u>  | <u>30</u> |
| <u>Note 10 – Mortgage Servicing Rights</u>  | <u>30</u> |
| <u>Note 11 – Income Taxes</u>   | <u>30</u> |
| <u>Note 12 - Certificates of Deposit</u>  | <u>31</u> |
| <u>Note 13 – Reclassifications</u>  | <u>31</u> |
| <u>Note 14 – Fair Value Disclosures</u>   | <u>31</u> |
| <u>Note 15 – Subsequent Event</u>   | <u>37</u> |
| <u>Note 16 – Impact of Recently Issued Accounting Standards</u>                                       | <u>37</u> |
| <u>Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>38</u> |
| <u>Forward-Looking Statements</u>   | <u>38</u> |
| <u>Critical Accounting Policies</u>   | <u>38</u> |
| <u>Use of Non-GAAP Financial Measures</u>   | <u>39</u> |
| <u>Executive Summary</u>  | <u>41</u> |
| <u>Net Interest Income</u>  | <u>42</u> |
| <u>Average Daily Balance Sheets</u>   | <u>45</u> |
| <u>Non-Interest Income</u>  | <u>46</u> |
| <u>Non-Interest Expense</u>   | <u>46</u> |
| <u>Income Taxes</u>   | <u>46</u> |
| <u>Investments</u>  | <u>46</u> |
| <u>Impaired Securities</u>  | <u>48</u> |
| <u>Federal Home Loan Bank Stock</u>   | <u>50</u> |
| <u>Loans and Loans Held for Sale</u>  | <u>50</u> |
| <u>Credit Risk Management and Allowance for Loan Losses</u>   | <u>52</u> |
| <u>Non-Performing Loans and Troubled Debt Restructured</u>  | <u>56</u> |
| <u>Impaired Loans</u>   | <u>57</u> |
| <u>Past Due Loans</u>   | <u>58</u> |
| <u>Potential Problem Loans and Loans in Process of Foreclosure</u>                                    | <u>58</u> |
| <u>Other Real Estate Owned</u>  | <u>59</u> |
| <u>Goodwill</u>   | <u>60</u> |
| <u>Liquidity Management</u>   | <u>60</u> |
| <u>Deposits</u>   | <u>60</u> |

|   |    |
|---|----|
| <u>Borrowed Funds</u>   | 60 |
| <u>Shareholders' Equity</u>   | 61 |
| <u>Off-Balance-Sheet Financial Instruments and Contractual Obligations</u>  | 61 |
| <u>Item 3 – Quantitative and Qualitative Disclosures About Market Risk</u>  | 62 |
| <u>Market-Risk Management</u>   | 62 |
| <u>Asset/Liability Management</u>   | 62 |
| <u>Interest Rate Risk Management</u>  | 63 |
| <u>Item 4: Controls and Procedures</u>                                      | 64 |
| <u>Part II – Other Information</u>  | 65 |
| <u>Item 1 – Legal Proceedings</u>   | 65 |
| <u>Item 1a – Risk Factors</u>   | 65 |
| <u>Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds</u> | 65 |
| <u>Item 3 – Default Upon Senior Securities</u>                              | 65 |
| <u>Item 4 – Other Information</u>   | 65 |
| <u>Item 5 – Exhibits</u>  | 66 |
| <u>Signatures</u>   | 68 |

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## Part I. Financial Information

Selected Financial Data (Unaudited)

The First Bancorp, Inc. and Subsidiary

| Dollars in thousands,<br>except for per share amounts  | For the nine months<br>ended<br>September 30, |             | For the quarters ended<br>September 30, |             |   |
|--|---|-------------|---|-------------|---|
|  | 2012  | 2011        | 2012                                    | 2011        |   |
| <b>Summary of Operations</b>                           |   |             |   |             |   |
| Interest Income  | \$39,131                                      | \$42,146    | \$12,892                                | \$13,898    |   |
| Interest Expense                                       | 9,737   | 11,193      | 3,222                                   | 3,670       |   |
| Net Interest Income                                    | 29,394  | 30,953      | 9,670                                   | 10,228      |   |
| Provision for Loan Losses                              | 6,300   | 5,600       | 1,400                                   | 1,500       |   |
| Non-Interest Income                                    | 8,556   | 6,591       | 2,492                                   | 2,080       |   |
| Non-Interest Expense                                   | 19,503  | 19,669      | 6,595                                   | 6,934       |   |
| Net Income   | 9,459   | 9,341       | 3,223                                   | 3,006       |   |
| <b>Per Common Share Data</b>                           |   |             |   |             |   |
| Basic Earnings per Share                               | \$0.91  | \$0.85      | \$0.31                                  | \$0.27      |   |
| Diluted Earnings per Share                             | 0.91  | 0.85        | 0.31                                    | 0.27        |   |
| Cash Dividends Declared                                | 0.585   | 0.585       | 0.195                                   | 0.195       |   |
| Book Value per Common Share                            | 14.64   | 14.11       | 14.64                                   | 14.11       |   |
| Tangible Book Value per Common Share                   | 11.83   | 11.28       | 11.83                                   | 11.28       |   |
| Market Value   | 17.55   | 12.59       | 17.55                                   | 12.59       |   |
| <b>Financial Ratios</b>                                |   |             |   |             |   |
| Return on Average Equity <sup>1</sup>                  | 8.86  | % 9.64      | % 8.90                                  | % 9.15      | % |
| Return on Average Tangible Equity <sup>1,2</sup>       | 10.36   | % 10.92     | % 10.39                                 | % 10.25     | % |
| Return on Average Assets <sup>1</sup>                  | 0.89  | % 0.87      | % 0.90                                  | % 0.83      | % |
| Average Equity to Average Assets                       | 10.90   | % 10.67     | % 11.02                                 | % 10.46     | % |
| Average Tangible Equity to Average Assets <sup>2</sup> | 8.95  | % 8.74      | % 9.07                                  | % 8.53      | % |
| Net Interest Margin Tax-Equivalent <sup>1,2</sup>      | 3.16  | % 3.29      | % 3.12                                  | % 3.24      | % |
| Dividend Payout Ratio                                  | 64.29   | % 68.82     | % 62.90                                 | % 72.22     | % |
| Allowance for Loan Losses/Total Loans                  | 1.69  | % 1.76      | % 1.69                                  | % 1.76      | % |
| Non-Performing Loans to Total Loans                    | 2.71  | % 2.42      | % 2.71                                  | % 2.42      | % |
| Non-Performing Assets to Total Assets                  | 2.04  | % 1.91      | % 2.04                                  | % 1.91      | % |
| Efficiency Ratio <sup>2</sup>                          | 50.74   | % 49.89     | % 50.73                                 | % 53.15     | % |
| <b>At Period End</b>                                   |   |             |   |             |   |
| Total Assets   | \$1,423,316                                   | \$1,427,038 | \$1,423,316                             | \$1,427,038 |   |
| Total Loans  | 869,871                                       | 868,573     | 869,871                                 | 868,573     |   |
| Total Investment Securities                            | 468,604                                       | 471,924     | 468,604                                 | 471,924     |   |
| Total Deposits   | 944,547                                       | 1,004,894   | 944,547                                 | 1,004,894   |   |
| Total Shareholders' Equity                             | 156,637                                       | 150,538     | 156,637                                 | 150,538     |   |

<sup>1</sup>Annualized using a 366-day basis in 2012 and 365-day basis in 2011<sup>2</sup>These ratios use non-GAAP financial measures. See Management's Discussion and Analysis of Financial Condition and Results of Operations for additional disclosures and information.

Item 1 – Financial Statements

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders  
The First Bancorp, Inc.

We have reviewed the accompanying interim consolidated financial information of The First Bancorp, Inc. and Subsidiary as of September 30, 2012 and 2011 and for the three- and nine-month periods then ended. These financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is to express an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying interim consolidated financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

/s/ Berry Dunn McNeil & Parker, LLC

Portland, Maine  
November 9, 2012

Page 2

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Consolidated Balance Sheets (Unaudited)  
The First Bancorp, Inc. and Subsidiary

|   | September 30,<br>2012 | December 31,<br>2011 | September 30,<br>2011 |
|---|-----------------------|----------------------|-----------------------|
| <u>Assets</u>   |                       |                      |                       |
| Cash and cash equivalents   | \$ 14,904,000         | \$ 14,115,000        | \$ 16,563,000         |
| Interest bearing deposits in other banks  | 681,000               | -                    | 100,000               |
| Securities available for sale   | 299,900,000           | 286,202,000          | 326,782,000           |
| Securities to be held to maturity (fair value of \$162,382,000 at September 30, 2012, \$130,677,000 at December 31, 2011 and \$137,227,000 at September 30, 2011) | 154,256,000           | 122,661,000          | 129,699,000           |
| Restricted equity securities, at cost   | 14,448,000            | 15,443,000           | 15,443,000            |
| Loans held for sale   | -                     | -                    | 230,000               |
| Loans   | 869,871,000           | 864,988,000          | 868,573,000           |
| Less allowance for loan losses  | 14,739,000            | 13,000,000           | 15,319,000            |
| Net loans   | 855,132,000           | 851,988,000          | 853,254,000           |
| Accrued interest receivable   | 5,425,000             | 4,835,000            | 5,018,000             |
| Premises and equipment, net   | 18,376,000            | 18,842,000           | 18,872,000            |
| Other real estate owned   | 5,471,000             | 4,094,000            | 6,310,000             |
| Goodwill  | 27,684,000            | 27,684,000           | 27,684,000            |
| Other assets  | 27,039,000            | 27,003,000           | 27,083,000            |
| Total assets  | \$ 1,423,316,000      | \$ 1,372,867,000     | \$ 1,427,038,000      |
| <u>Liabilities</u>  |                       |                      |                       |
| Demand deposits   | \$ 89,500,000         | \$ 75,750,000        | \$ 88,472,000         |
| NOW deposits  | 136,472,000           | 122,775,000          | 130,522,000           |
| Money market deposits   | 74,805,000            | 79,015,000           | 77,736,000            |
| Savings deposits  | 130,354,000           | 114,617,000          | 114,079,000           |
| Certificates of deposit   | 513,416,000           | 549,176,000          | 594,085,000           |
| Total deposits  | 944,547,000           | 941,333,000          | 1,004,894,000         |
| Borrowed funds – short term   | 164,592,000           | 135,500,000          | 135,452,000           |
| Borrowed funds – long term  | 140,157,000           | 130,163,000          | 120,164,000           |
| Other liabilities   | 17,383,000            | 15,013,000           | 15,990,000            |
| Total liabilities   | 1,266,679,000         | 1,222,009,000        | 1,276,500,000         |
| <u>Shareholders' equity</u>   |                       |                      |                       |
| Preferred stock, \$1,000 preference value per share   | 12,377,000            | 12,303,000           | 12,278,000            |
| Common stock, one cent par value per share  | 98,000                | 98,000               | 98,000                |
| Additional paid-in capital  | 46,205,000            | 45,829,000           | 45,706,000            |
| Retained earnings   | 88,541,000            | 85,314,000           | 84,360,000            |
| Accumulated other comprehensive income (loss)   |                       |                      |                       |
| Net unrealized gain on securities available-for-sale  | 9,488,000             | 7,401,000            | 8,155,000             |
| Net unrealized loss on postretirement benefit costs   | (72,000)              | (87,000)             | (59,000)              |
| Total shareholders' equity  | 156,637,000           | 150,858,000          | 150,538,000           |
| Total liabilities & shareholders' equity  | \$ 1,423,316,000      | \$ 1,372,867,000     | \$ 1,427,038,000      |
| <u>Common Stock</u>   |                       |                      |                       |
| Number of shares authorized   | 18,000,000            | 18,000,000           | 18,000,000            |
| Number of shares issued and outstanding   | 9,853,396             | 9,812,180            | 9,800,507             |
| Book value per common share   | \$ 14.64              | \$ 14.12             | \$ 14.11              |
| Tangible book value per common share  | \$ 11.83              | \$ 11.30             | \$ 11.28              |

See Report of Independent Registered Public Accounting Firm.

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





Consolidated Statements of Income and Comprehensive Income (Unaudited)  
The First Bancorp, Inc. and Subsidiary

|  | For the nine months ended<br>September 30, |              | For the quarters ended<br>September 30, |             |
|--|--|--------------|---|-------------|
|  | 2012                                       | 2011         | 2012                                    | 2011        |
| Interest income  |  |              |   |             |
| Interest and fees on loans                                 | \$28,006,000                               | \$30,088,000 | \$9,247,000                             | \$9,960,000 |
| Interest on deposits with other banks                      | 3,000                                      | 11,000       | 2,000                                   | 7,000       |
| Interest and dividends on investments                      | 11,122,000                                 | 12,047,000   | 3,643,000                               | 3,931,000   |
| Total interest income                                      | 39,131,000                                 | 42,146,000   | 12,892,000                              | 13,898,000  |
| Interest expense   |  |              |   |             |
| Interest on deposits                                       | 6,370,000                                  | 7,478,000    | 2,073,000                               | 2,397,000   |
| Interest on borrowed funds                                 | 3,367,000                                  | 3,715,000    | 1,149,000                               | 1,273,000   |
| Total interest expense                                     | 9,737,000                                  | 11,193,000   | 3,222,000                               | 3,670,000   |
| Net interest income  | 29,394,000                                 | 30,953,000   | 9,670,000                               | 10,228,000  |
| Provision for loan losses                                  | 6,300,000                                  | 5,600,000    | 1,400,000                               | 1,500,000   |
| Net interest income after provision for loan losses        | 23,094,000                                 | 25,353,000   | 8,270,000                               | 8,728,000   |
| Non-interest income  |  |              |   |             |
| Investment management and fiduciary income                 | 1,230,000                                  | 1,140,000    | 386,000                                 | 358,000     |
| Service charges on deposit accounts                        | 1,995,000                                  | 2,032,000    | 644,000                                 | 681,000     |
| Net securities gains                                       | 1,967,000                                  | 237,000      | -                                       | 8,000       |
| Mortgage origination and servicing income                  | 854,000                                    | 845,000      | 550,000                                 | 193,000     |
| Other operating income                                     | 2,510,000                                  | 2,337,000    | 912,000                                 | 840,000     |
| Total non-interest income                                  | 8,556,000                                  | 6,591,000    | 2,492,000                               | 2,080,000   |
| Non-interest expense                                       |  |              |   |             |
| Salaries and employee benefits                             | 9,485,000                                  | 9,255,000    | 3,283,000                               | 3,250,000   |
| Occupancy expense  | 1,247,000                                  | 1,194,000    | 428,000                                 | 367,000     |
| Furniture and equipment expense                            | 1,650,000                                  | 1,665,000    | 527,000                                 | 554,000     |
| FDIC insurance premiums                                    | 909,000                                    | 1,104,000    | 303,000                                 | 298,000     |
| Amortization of identified intangibles                     | 212,000                                    | 212,000      | 71,000                                  | 71,000      |
| Other operating expense                                    | 6,000,000                                  | 6,239,000    | 1,983,000                               | 2,394,000   |
| Total non-interest expense                                 | 19,503,000                                 | 19,669,000   | 6,595,000                               | 6,934,000   |
| Income before income taxes                                 | 12,147,000                                 | 12,275,000   | 4,167,000                               | 3,874,000   |
| Applicable income taxes                                    | 2,688,000                                  | 2,934,000    | 944,000                                 | 868,000     |
| NET INCOME   | \$9,459,000                                | \$9,341,000  | \$3,223,000                             | \$3,006,000 |
| Basic earnings per common share                            | \$0.91                                     | \$0.85       | \$0.31                                  | \$0.27      |
| Diluted earnings per common share                          | \$0.91                                     | \$0.85       | \$0.31                                  | \$0.27      |
| Other comprehensive income, net of tax                     |  |              |   |             |
| Net unrealized gain on securities available for sale       | 2,087,000                                  | 10,212,000   | 1,962,000                               | 5,957,000   |
| Unrecognized postretirement benefits transition obligation | 15,000                                     | 14,000       | 5,000                                   | 4,000       |
| Other comprehensive income                                 | 2,102,000                                  | 10,226,000   | 1,967,000                               | 5,961,000   |
| Comprehensive income                                       | \$11,561,000                               | \$19,567,000 | \$5,190,000                             | \$8,967,000 |

See Report of Independent Registered Public Accounting Firm.

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

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)  
The First Bancorp, Inc. and Subsidiary

|  | Preferred<br>stock | Common stock and<br>additional paid-in<br>Shares | capital<br>Amount | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income (loss) | Total<br>shareholders'<br>equity |
|--|--------------------|--|-------------------|----------------------|--|----------------------------------|
| Balance at December 31,<br>2010  | \$24,705,000       | 9,773,025  | \$45,572,000      | \$81,701,000         | \$ (2,130,000 )  | \$ 149,848,000                   |
| Net income   | -                  | -  | -                 | 9,341,000            | -  | 9,341,000                        |
| Net unrealized gain on<br>securities available for<br>sale, net of taxes of<br>\$5,500,000       | -                  | -  | -                 | -                    | 10,212,000   | 10,212,000                       |
| Unrecognized transition<br>obligation for<br>postretirement benefits, net<br>of taxes of \$8,000 | -                  | -  | -                 | -                    | 14,000   | 14,000                           |
| Comprehensive income   | -                  | -  | -                 | 9,341,000            | 10,226,000   | 19,567,000                       |
| Cash dividends declared  | -                  | -  | -                 | (6,682,000 )         | -  | (6,682,000 )                     |
| Equity compensation<br>expense   | -                  | -  | 17,000            | -                    | -  | 17,000                           |
| Amortization of premium<br>for preferred stock<br>issuance                                       | 73,000             | -  | (73,000 )         | -                    | -  | -                                |
| Payment to repurchase<br>preferred stock   | (12,500,000)       | -  | -                 | -                    | -  | (12,500,000 )                    |
| Proceeds from sale of<br>common stock  | -                  | 27,482   | 288,000           | -                    | -  | 288,000                          |
| Balance at September 30,<br>2011   | \$12,278,000       | 9,800,507  | \$45,804,000      | \$84,360,000         | \$ 8,096,000   | \$ 150,538,000                   |
| Balance at December 31,<br>2011  | \$12,303,000       | 9,812,180  | \$45,927,000      | \$85,314,000         | \$ 7,314,000   | \$ 150,858,000                   |
| Net income   | -                  | -  | -                 | 9,459,000            | -  | 9,459,000                        |
| Net unrealized gain on<br>securities available for<br>sale, net of taxes of<br>\$1,124,000       | -                  | -  | -                 | -                    | 2,087,000  | 2,087,000                        |
| Unrecognized transition<br>obligation for<br>postretirement benefits, net<br>of taxes of \$8,000 | -                  | -  | -                 | -                    | 15,000   | 15,000                           |
| Comprehensive income   | -                  | -  | -                 | 9,459,000            | 2,102,000  | 11,561,000                       |
| Cash dividends declared  | -                  | -  | -                 | (6,232,000 )         | -  | (6,232,000 )                     |
| Equity compensation<br>expense   | -                  | -  | 57,000            | -                    | -  | 57,000                           |
| Amortization of premium<br>for preferred stock<br>issuance                                       | 74,000             | -  | (74,000 )         | -                    | -  | -                                |

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|                                       |              |           |              |              |             |               |
|---------------------------------------|--------------|-----------|--------------|--------------|-------------|---------------|
| Proceeds from sale of<br>common stock | -            | 41,216    | 393,000      | -            | -           | 393,000       |
| Balance at September 30,<br>2012      | \$12,377,000 | 9,853,396 | \$46,303,000 | \$88,541,000 | \$9,416,000 | \$156,637,000 |

See Report of Independent Registered Public Accounting Firm.

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

Page 5

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Consolidated Statements of Cash Flows (Unaudited)  
The First Bancorp, Inc. and Subsidiary

|   | For the nine months ended |                       |
|---|---------------------------|-----------------------|
|   | September<br>30, 2012     | September 30,<br>2011 |
| Cash flows from operating activities  |                           |                       |
| Net income  | \$9,459,000               | \$9,341,000           |
| Adjustments to reconcile net income to net cash provided by operating activities  |                           |                       |
| Depreciation  | 992,000                   | 1,018,000             |
| Change in deferred taxes  | (929,000 )                | (644,000 )            |
| Provision for loan losses   | 6,300,000                 | 5,600,000             |
| Loans originated for resale   | (29,137,762)              | (33,416,000 )         |
| Proceeds from sales and transfers of loans  | 29,331,762                | 35,992,000            |
| Net gain on sale or call of securities  | (1,967,000 )              | (237,000 )            |
| Net (gain)/loss on sale of other real estate owned                                | 29,000                    | (13,000 )             |
| Provision for losses on other real estate owned                                   | 291,000                   | 800,000               |
| Equity compensation expense   | 57,000                    | 17,000                |
| Net (increase) decrease in other assets and accrued interest                      | (483,000 )                | 2,043,000             |
| Net increase (decrease) in other liabilities                                      | 1,478,000                 | (473,000 )            |
| Net (gain)/loss on disposal of premises and equipment                             | (30,000 )                 | 5,000                 |
| Net amortization of premiums on investments                                       | 2,125,000                 | 2,908,000             |
| Amortization of investment in limited partnership                                 | 357,000                   | 292,000               |
| Net acquisition amortization  | 173,000                   | 173,000               |
| Net cash provided by operating activities   | 18,046,000                | 23,406,000            |
| Cash flows from investing activities  |                           |                       |
| Purchase of Fed Funds sold  | (681,000 )                | -                     |
| Proceeds from sales of securities available for sale                              | 25,437,000                | 75,182,000            |
| Proceeds from maturities, payments and calls of securities available for sale     | 43,803,000                | 34,209,000            |
| Proceeds from maturities, payments and calls of securities to be held to maturity | 42,497,000                | 16,031,000            |
| Proceeds from sales of other real estate owned                                    | 2,077,000                 | 2,875,000             |
| Purchases of securities available for sale  | (79,941,000)              | (129,488,000)         |
| Purchases of securities to be held to maturity                                    | (74,230,000)              | (38,765,000 )         |
| Redemption of restricted equity securities  | 995,000                   | -                     |
| Net (increase) decrease in loans  | (13,218,000)              | 10,383,000            |
| Capital expenditures  | (554,000 )                | (915,000 )            |
| Proceeds from sale of equipment   | 58,000                    | -                     |
| Net cash used in investing activities   | (53,757,000)              | (30,488,000 )         |
| Cash flows from financing activities  |                           |                       |
| Net increase in demand, savings, and money market accounts                        | 38,974,000                | 44,480,000            |
| Net decrease in certificates of deposit   | (35,728,000)              | (14,072,000 )         |
| Net increase (decrease) in short-term borrowings                                  | 39,093,000                | (1,707,000 )          |
| Repurchase of preferred stock   | -                         | (12,500,000 )         |
| Proceeds from sale of common stock  | 393,000                   | 288,000               |
| Dividends paid  | (6,232,000 )              | (6,682,000 )          |
| Net cash provided by financing activities   | 36,500,000                | 9,807,000             |
| Net increase in cash and cash equivalents   | 789,000                   | 2,725,000             |
| Cash and cash equivalents at beginning of period                                  | 14,115,000                | 13,838,000            |
| Cash and cash equivalents at end of period  | \$14,904,000              | \$16,563,000          |
| Interest paid   | \$9,853,000               | \$11,418,000          |
| Income taxes paid   | \$2,060,000               | \$2,557,000           |

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Non-cash transactions

Net transfer from loans to other real estate owned

\$3,774,000      \$5,043,000

See Report of Independent Registered Public Accounting Firm.

Page 6

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Notes to Consolidated Financial Statements

## The First Bancorp, Inc. and Subsidiary

## Note 1 – Basis of Presentation

The First Bancorp, Inc. (the Company) is a financial holding company that owns all of the common stock of The First, N.A. (the Bank). The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of Management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions and balances are eliminated in consolidation. The income reported for the 2012 period is not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and notes included in the Company's annual report on Form 10-K for the year ended December 31, 2011.

## Subsequent Events

Events occurring subsequent to September 30, 2012, have been evaluated as to their potential impact to the financial statements.

Note 2 – Investment Securities

The following table summarizes the amortized cost and estimated fair value of investment securities at September 30, 2012:

|                                   | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair Value<br>(Estimated) |
|-----------------------------------|-------------------|---------------------|----------------------|---------------------------|
| Securities available for sale     |                   |                     |                      |                           |
| U.S. Treasury and agency          | \$-               | \$-                 | \$-                  | \$-                       |
| Mortgage-backed securities        | 183,126,000       | 6,408,000           | (97,000 )            | 189,437,000               |
| State and political subdivisions  | 100,614,000       | 8,363,000           | (22,000 )            | 108,955,000               |
| Corporate securities              | -                 | -                   | -                    | -                         |
| Other equity securities           | 1,563,000         | 49,000              | (104,000 )           | 1,508,000                 |
|                                   | \$285,303,000     | \$14,820,000        | \$(223,000 )         | \$299,900,000             |
| Securities to be held to maturity |                   |                     |                      |                           |
| U.S. Treasury and agency          | \$65,859,000      | \$390,000           | \$(21,000 )          | \$66,228,000              |
| Mortgage-backed securities        | 44,236,000        | 3,400,000           | (10,000 )            | 47,626,000                |
| State and political subdivisions  | 43,861,000        | 4,367,000           | -                    | 48,228,000                |
| Corporate securities              | 300,000           | -                   | -                    | 300,000                   |
|                                   | \$154,256,000     | \$8,157,000         | \$(31,000 )          | \$162,382,000             |
| Restricted equity securities      |                   |                     |                      |                           |
| Federal Home Loan Bank Stock      | \$13,412,000      | \$-                 | \$-                  | \$13,412,000              |
| Federal Reserve Bank Stock        | 1,036,000         | -                   | -                    | 1,036,000                 |
|                                   | \$14,448,000      | \$-                 | \$-                  | \$14,448,000              |



The following table summarizes the amortized cost and estimated fair value of investment securities at December 31, 2011:

|                                   | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair Value<br>(Estimated) |
|-----------------------------------|-------------------|---------------------|----------------------|---------------------------|
| Securities available for sale     |                   |                     |                      |                           |
| U.S. Treasury and agency          | \$-               | \$-                 | \$-                  | \$-                       |
| Mortgage-backed securities        | 191,924,000       | 6,486,000           | (178,000 )           | 198,232,000               |
| State and political subdivisions  | 80,259,000        | 5,484,000           | (17,000 )            | 85,726,000                |
| Corporate securities              | 1,098,000         | -                   | (287,000 )           | 811,000                   |
| Other equity securities           | 1,535,000         | 37,000              | (139,000 )           | 1,433,000                 |
|                                   | \$274,816,000     | \$12,007,000        | \$(621,000 )         | \$286,202,000             |
| Securities to be held to maturity |                   |                     |                      |                           |
| U.S. Treasury and agency          | \$19,390,000      | \$132,000           | \$-                  | \$19,522,000              |
| Mortgage-backed securities        | 56,800,000        | 3,900,000           | (3,000 )             | 60,697,000                |
| State and political subdivisions  | 46,171,000        | 4,159,000           | (172,000 )           | 50,158,000                |
| Corporate securities              | 300,000           | -                   | -                    | 300,000                   |
|                                   | \$122,661,000     | \$8,191,000         | \$(175,000 )         | \$130,677,000             |
| Restricted equity securities      |                   |                     |                      |                           |
| Federal Home Loan Bank Stock      | \$14,031,000      | \$-                 | \$-                  | \$14,031,000              |
| Federal Reserve Bank Stock        | 1,412,000         | -                   | -                    | 1,412,000                 |
|                                   | \$15,443,000      | \$-                 | \$-                  | \$15,443,000              |

The following table summarizes the amortized cost and estimated fair value of investment securities at September 30, 2011:

|                                   | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair Value<br>(Estimated) |
|-----------------------------------|-------------------|---------------------|----------------------|---------------------------|
| Securities available for sale     |                   |                     |                      |                           |
| U.S. Treasury and agency          | \$15,295,000      | \$1,199,000         | \$-                  | \$16,494,000              |
| Mortgage-backed securities        | 227,180,000       | 8,173,000           | (315,000 )           | 235,038,000               |
| State and political subdivisions  | 70,124,000        | 3,936,000           | (21,000 )            | 74,039,000                |
| Corporate securities              | 1,103,000         | -                   | (324,000 )           | 779,000                   |
| Other equity securities           | 534,000           | 33,000              | (135,000 )           | 432,000                   |
|                                   | \$314,236,000     | \$13,341,000        | \$(795,000 )         | \$326,782,000             |
| Securities to be held to maturity |                   |                     |                      |                           |
| U.S. Treasury and agency          | \$20,998,000      | \$180,000           | \$-                  | \$21,178,000              |
| Mortgage-backed securities        | 61,048,000        | 4,221,000           | (19,000 )            | 65,250,000                |
| State and political subdivisions  | 47,353,000        | 3,397,000           | (251,000 )           | 50,499,000                |
| Corporate securities              | 300,000           | -                   | -                    | 300,000                   |
|                                   | \$129,699,000     | \$7,798,000         | \$(270,000 )         | \$137,227,000             |
| Restricted equity securities      |                   |                     |                      |                           |
| Federal Home Loan Bank Stock      | \$14,031,000      | \$-                 | \$-                  | \$14,031,000              |
| Federal Reserve Bank Stock        | 1,412,000         | -                   | -                    | 1,412,000                 |
|                                   | \$15,443,000      | \$-                 | \$-                  | \$15,443,000              |



The following table summarizes the contractual maturities of investment securities at September 30, 2012:

|                      | Securities available for sale |                        | Securities to be held to maturity |                        |
|----------------------|-------------------------------|------------------------|-----------------------------------|------------------------|
|                      | Amortized Cost                | Fair Value (Estimated) | Amortized Cost                    | Fair Value (Estimated) |
|                      | Due in 1 year or less         | \$4,592,000            | \$4,652,000                       | \$1,376,000            |
| Due in 1 to 5 years  | 50,173,000                    | 51,286,000             | 11,046,000                        | 11,569,000             |
| Due in 5 to 10 years | 16,908,000                    | 17,965,000             | 20,519,000                        | 22,376,000             |
| Due after 10 years   | 212,067,000                   | 224,489,000            | 121,315,000                       | 127,057,000            |
| Equity securities    | 1,563,000                     | 1,508,000              | -                                 | -                      |
|                      | \$285,303,000                 | \$299,900,000          | \$154,256,000                     | \$162,382,000          |

The following table summarizes the contractual maturities of investment securities at December 31, 2011:

|                      | Securities available for sale |                        | Securities to be held to maturity |                        |
|----------------------|-------------------------------|------------------------|-----------------------------------|------------------------|
|                      | Amortized Cost                | Fair Value (Estimated) | Amortized Cost                    | Fair Value (Estimated) |
|                      | Due in 1 year or less         | \$6,617,000            | \$6,773,000                       | \$5,179,000            |
| Due in 1 to 5 years  | 18,792,000                    | 19,473,000             | 10,085,000                        | 10,654,000             |
| Due in 5 to 10 years | 23,219,000                    | 24,065,000             | 23,027,000                        | 24,694,000             |
| Due after 10 years   | 224,653,000                   | 234,458,000            | 84,370,000                        | 90,102,000             |
| Equity securities    | 1,535,000                     | 1,433,000              | -                                 | -                      |
|                      | \$274,816,000                 | \$286,202,000          | \$122,661,000                     | \$130,677,000          |

The following table summarizes the contractual maturities of investment securities at September 30, 2011:

|                      | Securities available for sale |                        | Securities to be held to maturity |                        |
|----------------------|-------------------------------|------------------------|-----------------------------------|------------------------|
|                      | Amortized Cost                | Fair Value (Estimated) | Amortized Cost                    | Fair Value (Estimated) |
|                      | Due in 1 year or less         | \$4,394,000            | \$4,450,000                       | \$152,000              |
| Due in 1 to 5 years  | 11,188,000                    | 11,748,000             | 14,848,000                        | 15,415,000             |
| Due in 5 to 10 years | 34,872,000                    | 36,698,000             | 22,158,000                        | 23,608,000             |
| Due after 10 years   | 263,248,000                   | 273,454,000            | 92,541,000                        | 98,051,000             |
| Equity securities    | 534,000                       | 432,000                | -                                 | -                      |
|                      | \$314,236,000                 | \$326,782,000          | \$129,699,000                     | \$137,227,000          |

At September 30, 2012, securities with a fair value of \$171,004,000 were pledged to secure public deposits, repurchase agreements, and for other purposes as required by law. This compares to securities with a fair value of \$141,506,000 as of December 31, 2011 and \$171,436,000 at September 30, 2011, pledged for the same purposes. Gains and losses on the sale of securities available for sale are computed by subtracting the amortized cost at the time of sale from the security's selling price, net of accrued interest to be received. The following table shows securities gains and losses for the nine months and quarters ended September 30, 2012 and 2011:

|  | For the nine months ended September 30, | For the quarters ended September 30, |
|--|---|--------------------------------------|
|--|---|--------------------------------------|

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|                                   | 2012         | 2011         | 2012      | 2011    |
|-----------------------------------|--------------|--------------|-----------|---------|
| Proceeds from sales of securities | \$25,437,000 | \$75,182,000 | \$300,000 | \$6,000 |
| Gross realized gains              | 2,256,000    | 964,000      | -         | 7,000   |
| Gross realized losses             | (289,000 )   | (727,000 )   | -         | 1,000   |
| Net gain                          | \$1,967,000  | \$237,000    | -         | \$8,000 |
| Related income taxes              | \$688,000    | \$83,000     | \$-       | \$3,000 |

Page 9

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The following table summarizes activity in the unrealized gain or loss on available for sale securities included in other comprehensive income for the nine months and quarters ended September 30, 2012 and 2011.

|  | For the nine months ended |               | For the quarters ended |             |
|--|---------------------------|---------------|------------------------|-------------|
|  | September 30, 2012        | 2011          | September 30, 2012     | 2011        |
| Balance at beginning of period             | \$7,401,000               | \$(2,057,000) | \$7,526,000            | \$2,198,000 |
| Unrealized gains arising during the period | 5,178,000                 | 15,949,000    | 3,019,000              | 9,174,000   |
| Realized gains during the period           | (1,967,000)               | (237,000)     | -                      | (8,000)     |
| Related deferred taxes                     | (1,124,000)               | (5,500,000)   | (1,057,000)            | (3,209,000) |
| Net change                                 | 2,087,000                 | 10,212,000    | 1,962,000              | 5,957,000   |
| Balance at end of period                   | \$9,488,000               | \$8,155,000   | \$9,488,000            | \$8,155,000 |

Management reviews securities with unrealized losses for other than temporary impairment. As of September 30, 2012, there were 20 securities with unrealized losses held in the Company's portfolio. These securities were temporarily impaired as a result of changes in interest rates reducing their fair value, of which seven had been temporarily impaired for 12 months or more. At the present time, there have been no material changes in the credit quality of these securities resulting in other than temporary impairment, and in Management's opinion, no additional write-down for other-than-temporary impairment is warranted. Information regarding securities temporarily impaired as of September 30, 2012 is summarized below:

|                                  | Less than 12 months    |                   | 12 months or more      |                   | Total                  |                   |
|----------------------------------|------------------------|-------------------|------------------------|-------------------|------------------------|-------------------|
|                                  | Fair Value (Estimated) | Unrealized Losses | Fair Value (Estimated) | Unrealized Losses | Fair Value (Estimated) | Unrealized Losses |
| U.S. Treasury and agency         | \$1,199,000            | \$(21,000)        | \$-                    | \$-               | \$1,199,000            | \$(21,000)        |
| Mortgage-backed securities       | 12,990,000             | (76,000)          | 3,104,000              | (31,000)          | 16,094,000             | (107,000)         |
| State and political subdivisions | 1,123,000              | (22,000)          | -                      | -                 | 1,123,000              | (22,000)          |
| Corporate securities             | -                      | -                 | -                      | -                 | -                      | -                 |
| Other equity securities          | 3,000                  | -                 | 191,000                | (104,000)         | 194,000                | (104,000)         |
|                                  | \$15,315,000           | \$(119,000)       | \$3,295,000            | \$(135,000)       | \$18,610,000           | \$(254,000)       |

As of December 31, 2011, there were 29 securities with unrealized losses held in the Company's portfolio. These securities were temporarily impaired as a result of changes in interest rates reducing their fair value, of which 11 had been temporarily impaired for 12 months or more. Information regarding securities temporarily impaired as of December 31, 2011 is summarized below:

|                                  | Less than 12 months    |                   | 12 months or more      |                   | Total                  |                   |
|----------------------------------|------------------------|-------------------|------------------------|-------------------|------------------------|-------------------|
|                                  | Fair Value (Estimated) | Unrealized Losses | Fair Value (Estimated) | Unrealized Losses | Fair Value (Estimated) | Unrealized Losses |
| U.S. Treasury and agency         | \$-                    | \$-               | \$-                    | \$-               | \$-                    | \$-               |
| Mortgage-backed securities       | 12,489,000             | (25,000)          | 6,780,000              | (156,000)         | 19,269,000             | (181,000)         |
| State and political subdivisions | 1,984,000              | (17,000)          | 1,667,000              | (172,000)         | 3,651,000              | (189,000)         |
| Corporate securities             | -                      | -                 | 811,000                | (287,000)         | 811,000                | (287,000)         |
| Other equity securities          | 154,000                | (120,000)         | 34,000                 | (19,000)          | 188,000                | (139,000)         |
|                                  | \$14,627,000           | \$(162,000)       | \$9,292,000            | \$(634,000)       | \$23,919,000           | \$(796,000)       |

As of September 30, 2011, there were 29 securities with unrealized losses held in the Company's portfolio. These securities were temporarily impaired as a result of changes in interest rates reducing their fair value, of which 12 had been temporarily impaired for 12 months or more. Information regarding securities temporarily impaired as of September 30, 2011 is summarized below:

|                                  | Less than 12 months       |                      | 12 months or more         |                      | Total                     |                      |
|----------------------------------|---------------------------|----------------------|---------------------------|----------------------|---------------------------|----------------------|
|                                  | Fair Value<br>(Estimated) | Unrealized<br>Losses | Fair Value<br>(Estimated) | Unrealized<br>Losses | Fair Value<br>(Estimated) | Unrealized<br>Losses |
| U.S. Treasury and agency         | \$-                       | \$-                  | \$-                       | \$-                  | \$-                       | \$-                  |
| Mortgage-backed securities       | 11,669,000                | (46,000 )            | 6,984,000                 | (288,000 )           | 18,653,000                | (334,000 )           |
| State and political subdivisions | 1,748,000                 | (21,000 )            | 1,569,000                 | (251,000 )           | 3,317,000                 | (272,000 )           |
| Corporate securities             | -                         | -                    | 779,000                   | (324,000 )           | 779,000                   | (324,000 )           |
| Other equity securities          | 151,000                   | (119,000 )           | 36,000                    | (16,000 )            | 187,000                   | (135,000 )           |
|                                  | \$13,568,000              | \$(186,000 )         | \$9,368,000               | \$(879,000 )         | \$22,936,000              | \$(1,065,000)        |

The Bank is a member of the Federal Home Loan Bank ("FHLB") of Boston, a cooperatively owned wholesale bank for housing and finance in the six New England States. As a requirement of membership in the FHLB, the Bank must own a minimum required amount of FHLB stock, calculated periodically based primarily on its level of borrowings from the FHLB. The Bank uses the FHLB for much of its wholesale funding needs. As of September 30, 2012 and 2011, and December 31, 2011, the Bank's investment in FHLB stock totaled \$13,412,000, \$14,031,000 and \$14,031,000 respectively. FHLB stock is a non-marketable equity security and therefore is reported at cost, which equals par value.

#### Note 3 – Loans

The following table shows the composition of the Company's loan portfolio as of September 30, 2012 and 2011 and at December 31, 2011:

|                            | September 30, 2012 |        | December 31, 2011 |        | September 30, 2011 |        |
|----------------------------|--------------------|--------|-------------------|--------|--------------------|--------|
| Commercial                 |                    |        |                   |        |                    |        |
| Real estate                | \$256,531,000      | 29.5 % | \$255,424,000     | 29.5 % | \$257,910,000      | 29.7 % |
| Construction               | 21,905,000         | 2.5 %  | 32,574,000        | 3.8 %  | 30,345,000         | 3.5 %  |
| Other                      | 83,703,000         | 9.6 %  | 86,982,000        | 10.1 % | 96,045,000         | 11.1 % |
| Municipal                  | 16,448,000         | 1.9 %  | 16,221,000        | 1.9 %  | 19,853,000         | 2.3 %  |
| Residential                |                    |        |                   |        |                    |        |
| Term                       | 369,949,000        | 42.5 % | 341,286,000       | 39.5 % | 329,730,000        | 38.0 % |
| Construction               | 6,528,000          | 0.8 %  | 10,469,000        | 1.2 %  | 12,061,000         | 1.4 %  |
| Home equity line of credit | 100,099,000        | 11.5 % | 105,244,000       | 12.1 % | 105,891,000        | 12.1 % |
| Consumer                   | 14,708,000         | 1.7 %  | 16,788,000        | 1.9 %  | 16,738,000         | 1.9 %  |
| Total                      | \$869,871,000      | 100.0% | \$864,988,000     | 100.0% | \$868,573,000      | 100.0% |

Loan balances include net deferred loan costs of \$1,694,000 as of September 30, 2012, \$1,386,000 as of December 31, 2011, and \$1,336,000 as of September 30, 2011. Pursuant to collateral agreements, qualifying first mortgage loans, which totaled \$244,794,000 at September 30, 2012, \$211,597,000 at December 31, 2011, and \$190,890,000 at September 30, 2011, were used to collateralize borrowings from the Federal Home Loan Bank of Boston. In addition, commercial, construction and home equity loans totaling \$234,200,000 at September 30, 2012, \$218,417,000 at December 31, 2011, and \$310,230,000 at September 30, 2011, were used to collateralize a standby line of credit at the Federal Reserve Bank of Boston that is currently unused.

Loans on non-accrual status totaled \$23,573,000 at September 30, 2012, \$27,806,000 at December 31, 2011 and \$20,980,000 at September 30, 2011. Loans past due 90 days or greater which are accruing interest totaled \$1,787,000 at September 30, 2012, \$1,170,000 at December 31, 2011 and \$1,291,000 at September 30, 2011. The Company continues to accrue interest on these loans because it believes collection of principal and interest is reasonably assured.

Page 11

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Information on the past-due status of loans by class of financing receivable as of September 30, 2012, is presented in the following table:

|                               | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90+ Days<br>Past Due | All<br>Past Due | Current        | Total          | 90+ Days<br>&<br>Accruing |
|-------------------------------|------------------------|------------------------|----------------------|-----------------|----------------|----------------|---------------------------|
| Commercial                    |                        |                        |                      |                 |                |                |                           |
| Real estate                   | \$ 190,000             | \$ 102,000             | \$ 2,105,000         | \$ 2,397,000    | \$ 254,134,000 | \$ 256,531,000 | \$ 283,000                |
| Construction                  | 31,000                 | -                      | 154,000              | 185,000         | 21,720,000     | 21,905,000     | -                         |
| Other                         | 448,000                | 248,000                | 1,790,000            | 2,486,000       | 81,217,000     | 83,703,000     | -                         |
| Municipal                     | -                      | -                      | -                    | -               | 16,448,000     | 16,448,000     | -                         |
| Residential                   |                        |                        |                      |                 |                |                |                           |
| Term                          | 1,436,000              | 2,536,000              | 9,047,000            | 13,019,000      | 356,930,000    | 369,949,000    | 1,442,000                 |
| Construction                  | -                      | -                      | 23,000               | 23,000          | 6,505,000      | 6,528,000      | -                         |
| Home equity line<br>of credit | 358,000                | -                      | 1,000,000            | 1,358,000       | 98,741,000     | 100,099,000    | -                         |
| Consumer                      | 169,000                | 19,000                 | 63,000               | 251,000         | 14,457,000     | 14,708,000     | 62,000                    |
| Total                         | \$ 2,632,000           | \$ 2,905,000           | \$ 14,182,000        | \$ 19,719,000   | \$ 850,152,000 | \$ 869,871,000 | \$ 1,787,000              |

Information on the past-due status of loans by class of financing receivable as of December 31, 2011, is presented in the following table:

|                               | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90+ Days<br>Past Due | All<br>Past Due | Current        | Total          | 90+ Days<br>&<br>Accruing |
|-------------------------------|------------------------|------------------------|----------------------|-----------------|----------------|----------------|---------------------------|
| Commercial                    |                        |                        |                      |                 |                |                |                           |
| Real estate                   | \$ 1,367,000           | \$ 1,505,000           | \$ 3,992,000         | \$ 6,864,000    | \$ 248,560,000 | \$ 255,424,000 | \$ -                      |
| Construction                  | -                      | 174,000                | 1,603,000            | 1,777,000       | 30,797,000     | 32,574,000     | -                         |
| Other                         | 665,000                | 766,000                | 1,192,000            | 2,623,000       | 84,359,000     | 86,982,000     | 52,000                    |
| Municipal                     | -                      | -                      | -                    | -               | 16,221,000     | 16,221,000     | -                         |
| Residential                   |                        |                        |                      |                 |                |                |                           |
| Term                          | 1,933,000              | 1,398,000              | 8,843,000            | 12,174,000      | 329,112,000    | 341,286,000    | 1,118,000                 |
| Construction                  | -                      | -                      | 1,198,000            | 1,198,000       | 9,271,000      | 10,469,000     | -                         |
| Home equity line<br>of credit | 480,000                | -                      | 1,134,000            | 1,614,000       | 103,630,000    | 105,244,000    | -                         |
| Consumer                      | 230,000                | 101,000                | 16,000               | 347,000         | 16,441,000     | 16,788,000     | -                         |
| Total                         | \$ 4,675,000           | \$ 3,944,000           | \$ 17,978,000        | \$ 26,597,000   | \$ 838,391,000 | \$ 864,988,000 | \$ 1,170,000              |

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Information on the past-due status of loans by class of financing receivable as of September 30, 2011, is presented in the following table:

|                               | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90+ Days<br>Past Due | All<br>Past Due | Current        | Total          | 90+ Days<br>&<br>Accruing |
|-------------------------------|------------------------|------------------------|----------------------|-----------------|----------------|----------------|---------------------------|
| Commercial                    |                        |                        |                      |                 |                |                |                           |
| Real estate                   | \$ 1,337,000           | \$ 341,000             | \$ 3,437,000         | \$ 5,115,000    | \$ 252,795,000 | \$ 257,910,000 | \$ -                      |
| Construction                  | -                      | -                      | 35,000               | 35,000          | 30,310,000     | 30,345,000     | -                         |
| Other                         | 820,000                | 155,000                | 802,000              | 1,777,000       | 94,268,000     | 96,045,000     | 71,000                    |
| Municipal                     | -                      | -                      | -                    | -               | 19,853,000     | 19,853,000     | -                         |
| Residential                   |                        |                        |                      |                 |                |                |                           |
| Term                          | 1,274,000              | 954,000                | 7,945,000            | 10,173,000      | 319,557,000    | 329,730,000    | 1,213,000                 |
| Construction                  | -                      | -                      | 396,000              | 396,000         | 11,665,000     | 12,061,000     | -                         |
| Home equity line<br>of credit | 232,000                | 13,000                 | 1,234,000            | 1,479,000       | 104,412,000    | 105,891,000    | -                         |
| Consumer                      | 115,000                | 25,000                 | 7,000                | 147,000         | 16,591,000     | 16,738,000     | 7,000                     |
| Total                         | \$ 3,778,000           | \$ 1,488,000           | \$ 13,856,000        | \$ 19,122,000   | \$ 849,451,000 | \$ 868,573,000 | \$ 1,291,000              |

For all classes, loans are placed on non-accrual status when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement or when principal and interest is 90 days or more past due unless the loan is both well secured and in the process of collection (in which case the loan may continue to accrue interest in spite of its past due status). A loan is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. A loan is "in the process of collection" if collection of the loan is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

Information on nonaccrual loans as of September 30, 2012 and 2011 and at December 31, 2011 is presented in the following table:

|                            | September<br>30, 2012 | December<br>31, 2011 | September<br>30, 2011 |
|----------------------------|-----------------------|----------------------|-----------------------|
| Commercial                 |                       |                      |                       |
| Real estate                | \$ 5,200,000          | \$ 7,064,000         | \$ 6,056,000          |
| Construction               | 3,546,000             | 2,350,000            | 792,000               |
| Other                      | 3,030,000             | 5,784,000            | 1,327,000             |
| Municipal                  | -                     | -                    | -                     |
| Residential                |                       |                      |                       |
| Term                       | 10,745,000            | 10,194,000           | 11,073,000            |
| Construction               | 23,000                | 1,198,000            | 396,000               |
| Home equity line of credit | 1,028,000             | 1,163,000            | 1,234,000             |
| Consumer                   | 1,000                 | 53,000               | 102,000               |
| Total                      | \$ 23,573,000         | \$ 27,806,000        | \$ 20,980,000         |

Impaired loans include restructured loans and loans placed on non-accrual. These loans are measured at the present value of expected future cash flows discounted at the loan's effective interest rate or at the fair value of the collateral if the loan is collateral dependent. If the measure of an impaired loan is lower than the recorded investment in the loan

and estimated selling costs, a specific reserve is established for the difference.



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A breakdown of impaired loans by class of financing receivable as of and for the period ended September 30, 2012, is presented in the following table:

|                                   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | For the nine months<br>ended<br>September 30, 2012 |                                  | For the quarter ended<br>September 30, 2012 |                                  |
|-----------------------------------|------------------------|--------------------------------|----------------------|--|----------------------------------|---|----------------------------------|
|                                   |                        |                                |                      | Average<br>Recorded<br>Investment                  | Recognized<br>Interest<br>Income | Average<br>Recorded<br>Investment           | Recognized<br>Interest<br>Income |
| <u>With No Related Allowance</u>  |                        |                                |                      |  |                                  |   |                                  |
| Commercial                        |                        |                                |                      |  |                                  |   |                                  |
| Real estate                       | \$ 10,142,000          | \$ 10,858,000                  | \$-                  | \$ 10,238,000                                      | \$ 134,000                       | \$ 11,257,000                               | \$ 23,000                        |
| Construction                      | 4,694,000              | 4,694,000                      | -                    | 2,319,000  | 34,000                           | 2,578,000                                   | 8,000                            |
| Other                             | 2,362,000              | 2,543,000                      | -                    | 2,548,000  | 22,000                           | 2,223,000                                   | 6,000                            |
| Municipal                         | -                      | -                              | -                    | -  | -                                | -   | -                                |
| Residential                       |                        |                                |                      |  |                                  |   |                                  |
| Term                              | 8,414,000              | 8,870,000                      | -                    | 9,267,000  | 102,000                          | 8,477,000                                   | 31,000                           |
| Construction                      | 23,000                 | 272,000                        | -                    | 747,000  | -                                | 481,000                                     | -                                |
| Home equity line of<br>credit     | 957,000                | 1,076,000                      | -                    | 868,000  | 14,000                           | 1,089,000                                   | 14,000                           |
| Consumer                          | -                      | -                              | -                    | 4,000  | -                                | -   | -                                |
|                                   | \$ 26,592,000          | \$ 28,313,000                  | \$-                  | \$ 25,991,000                                      | \$ 306,000                       | \$ 26,105,000                               | \$ 82,000                        |
| <u>With an Allowance Recorded</u> |                        |                                |                      |  |                                  |   |                                  |
| Commercial                        |                        |                                |                      |  |                                  |   |                                  |
| Real estate                       | \$ 6,179,000           | \$ 6,416,000                   | \$ 1,416,000         | \$ 4,058,000                                       | \$ 113,000                       | \$ 4,119,000                                | \$ 97,000                        |
| Construction                      | 1,951,000              | 1,951,000                      | 696,000              | 1,613,000  | 61,000                           | 2,086,000                                   | 24,000                           |
| Other                             | 2,543,000              | 2,573,000                      | 1,240,000            | 2,105,000  | 28,000                           | 2,290,000                                   | 10,000                           |
| Municipal                         | -                      | -                              | -                    | -  | -                                | -   | -                                |
| Residential                       |                        |                                |                      |  |                                  |   |                                  |
| Term                              | 10,891,000             | 11,066,000                     | 1,494,000            | 9,215,000  | 202,000                          | 10,672,000                                  | 75,000                           |
| Construction                      | -                      | -                              | -                    | 348,000  | -                                | 111,000                                     | -                                |
| Home equity line of<br>credit     | 488,000                | 488,000                        | 215,000              | 563,000  | -                                | 558,000                                     | -                                |
| Consumer                          | 1,000                  | 1,000                          | 1,000                | 12,000   | -                                | 6,000                                       | -                                |
|                                   | \$ 22,053,000          | \$ 22,495,000                  | \$ 5,062,000         | \$ 17,914,000                                      | \$ 404,000                       | \$ 19,842,000                               | \$ 206,000                       |
| <u>Total</u>                      |                        |                                |                      |  |                                  |   |                                  |
| Commercial                        |                        |                                |                      |  |                                  |   |                                  |
| Real estate                       | \$ 16,321,000          | \$ 17,274,000                  | \$ 1,416,000         | \$ 14,296,000                                      | \$ 247,000                       | \$ 15,376,000                               | \$ 120,000                       |
| Construction                      | 6,645,000              | 6,645,000                      | 696,000              | 3,931,000  | 95,000                           | 4,664,000                                   | 32,000                           |
| Other                             | 4,905,000              | 5,116,000                      | 1,240,000            | 4,653,000  | 50,000                           | 4,513,000                                   | 16,000                           |
| Municipal                         | -                      | -                              | -                    | -  | -                                | -   | -                                |
| Residential                       |                        |                                |                      |  |                                  |   |                                  |
| Term                              | 19,305,000             | 19,936,000                     | 1,494,000            | 18,482,000   | 304,000                          | 19,149,000                                  | 106,000                          |
| Construction                      | 23,000                 | 272,000                        | -                    | 1,095,000  | -                                | 592,000                                     | -                                |
| Home equity line of<br>credit     | 1,445,000              | 1,564,000                      | 215,000              | 1,432,000  | 14,000                           | 1,647,000                                   | 14,000                           |
| Consumer                          | 1,000                  | 1,000                          | 1,000                | 16,000   | -                                | 6,000                                       | -                                |
|                                   | \$ 48,645,000          | \$ 50,808,000                  | \$ 5,062,000         | \$ 43,905,000                                      | \$ 710,000                       | \$ 45,947,000                               | \$ 288,000                       |

Substantially all interest income recognized on impaired loans for all classes of financing receivables was recognized on a cash basis as received.

Page 14

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A breakdown of impaired loans by class of financing receivable as of and for the year ended December 31, 2011, is presented in the following table:

|                                   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Recognized<br>Interest<br>Income |
|-----------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| <u>With No Related Allowance</u>  |                        |                                |                      |                                   |                                  |
| Commercial                        |                        |                                |                      |                                   |                                  |
| Real estate                       | \$5,584,000            | \$5,584,000                    | \$-                  | \$5,212,000                       | \$ 23,000                        |
| Construction                      | 5,172,000              | 5,172,000                      | -                    | 1,072,000                         | 143,000                          |
| Other                             | 6,022,000              | 6,022,000                      | -                    | 1,918,000                         | 28,000                           |
| Municipal                         | -                      | -                              | -                    | -                                 | -                                |
| Residential                       |                        |                                |                      |                                   |                                  |
| Term                              | 9,875,000              | 9,875,000                      | -                    | 9,493,000                         | 54,000                           |
| Construction                      | 468,000                | 468,000                        | -                    | 961,000                           | -                                |
| Home equity line of credit        | 739,000                | 739,000                        | -                    | 646,000                           | -                                |
| Consumer                          | 37,000                 | 37,000                         | -                    | 39,000                            | -                                |
|                                   | \$27,897,000           | \$27,897,000                   | \$-                  | \$19,341,000                      | \$ 248,000                       |
| <u>With an Allowance Recorded</u> |                        |                                |                      |                                   |                                  |
| Commercial                        |                        |                                |                      |                                   |                                  |
| Real estate                       | \$4,557,000            | \$4,557,000                    | \$808,000            | \$2,307,000                       | \$ 103,000                       |
| Construction                      | 530,000                | 530,000                        | 33,000               | 247,000                           | -                                |
| Other                             | 1,020,000              | 1,020,000                      | 402,000              | 681,000                           | 19,000                           |
| Municipal                         | -                      | -                              | -                    | -                                 | -                                |
| Residential                       |                        |                                |                      |                                   |                                  |
| Term                              | 6,946,000              | 6,946,000                      | 478,000              | 5,628,000                         | 228,000                          |
| Construction                      | 730,000                | 730,000                        | 235,000              | 244,000                           | -                                |
| Home equity line of credit        | 424,000                | 424,000                        | 91,000               | 272,000                           | -                                |
| Consumer                          | 16,000                 | 16,000                         | 11,000               | 57,000                            | -                                |
|                                   | \$14,223,000           | \$14,223,000                   | \$2,058,000          | \$9,436,000                       | \$ 350,000                       |
| <u>Total</u>                      |                        |                                |                      |                                   |                                  |
| Commercial                        |                        |                                |                      |                                   |                                  |
| Real estate                       | \$10,141,000           | \$10,141,000                   | \$808,000            | \$7,519,000                       | \$ 126,000                       |
| Construction                      | 5,702,000              | 5,702,000                      | 33,000               | 1,318,000                         | 143,000                          |
| Other                             | 7,042,000              | 7,042,000                      | 402,000              | 2,600,000                         | 47,000                           |
| Municipal                         | -                      | -                              | -                    | -                                 | -                                |
| Residential                       |                        |                                |                      |                                   |                                  |
| Term                              | 16,821,000             | 16,821,000                     | 478,000              | 15,121,000                        | 282,000                          |
| Construction                      | 1,198,000              | 1,198,000                      | 235,000              | 1,205,000                         | -                                |
| Home equity line of credit        | 1,163,000              | 1,163,000                      | 91,000               | 918,000                           | -                                |
| Consumer                          | 53,000                 | 53,000                         | 11,000               | 96,000                            | -                                |
|                                   | \$42,120,000           | \$42,120,000                   | \$2,058,000          | \$28,777,000                      | \$ 598,000                       |

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A breakdown of impaired loans by class of financing receivable as of and for the period ended September 30, 2011, is presented in the following table:

|                                   | Recorded Investment | Unpaid Principal Balance | Related Allowance | For the nine months ended September 30, 2011 |                            | For the quarter ended September 30, 2011 |                            |
|-----------------------------------|---------------------|--------------------------|-------------------|--|----------------------------|--|----------------------------|
|                                   |                     |                          |                   | Average Recorded Investment                  | Recognized Interest Income | Average Recorded Investment              | Recognized Interest Income |
| <u>With No Related Allowance</u>  |                     |                          |                   |  |                            |  |                            |
| Commercial                        |                     |                          |                   |  |                            |  |                            |
| Real estate                       | \$5,008,000         | \$5,008,000              | \$-               | \$5,268,000                                  | \$-                        | \$5,384,000                              | \$-                        |
| Construction                      | 792,000             | 792,000                  | -                 | 670,000                                      | -                          | 775,000                                  | -                          |
| Other                             | 1,295,000           | 1,295,000                | -                 | 1,150,000                                    | -                          | 1,215,000                                | -                          |
| Municipal                         | -                   | -                        | -                 | -  | -                          | -  | -                          |
| Residential                       |                     |                          |                   |  |                            |  |                            |
| Term                              | 10,104,000          | 10,104,000               | -                 | 9,482,000                                    | -                          | 10,650,000                               | -                          |
| Construction                      | 314,000             | 314,000                  | -                 | 1,203,000                                    | -                          | 328,000                                  | -                          |
| Home equity line of credit        | 886,000             | 886,000                  | -                 | 618,000                                      | -                          | 1,018,000                                | -                          |
| Consumer                          | 38,000              | 38,000                   | -                 | 40,000                                       | -                          | 38,000                                   | -                          |
|                                   | \$18,437,000        | \$18,437,000             | \$-               | \$18,431,000                                 | \$-                        | \$19,408,000                             | \$-                        |
| <u>With an Allowance Recorded</u> |                     |                          |                   |  |                            |  |                            |
| Commercial                        |                     |                          |                   |  |                            |  |                            |
| Real estate                       | \$2,731,000         | \$2,731,000              | \$636,000         | \$1,858,000                                  | \$43,000                   | \$1,532,000                              | \$15,000                   |
| Construction                      | -                   | -                        | -                 | 151,000                                      | -                          | -  | -                          |
| Other                             | 645,000             | 645,000                  | 352,000           | 651,000                                      | 16,000                     | 648,000                                  | 6,000                      |
| Municipal                         | -                   | -                        | -                 | -  | -                          | -  | -                          |
| Residential                       |                     |                          |                   |  |                            |  |                            |
| Term                              | 5,963,000           | 5,963,000                | 398,000           | 5,370,000                                    | 187,000                    | 5,602,000                                | 63,000                     |
| Construction                      | 82,000              | 82,000                   | 82,000            | 155,000                                      | -                          | 82,000                                   | -                          |
| Home equity line of credit        | 348,000             | 348,000                  | 95,000            | 247,000                                      | -                          | 230,000                                  | -                          |
| Consumer                          | 64,000              | 64,000                   | 64,000            | 67,000                                       | -                          | 64,000                                   | -                          |
|                                   | \$9,833,000         | \$9,833,000              | \$1,627,000       | \$8,499,000                                  | \$246,000                  | \$8,158,000                              | \$84,000                   |
| <u>Total</u>                      |                     |                          |                   |  |                            |  |                            |
| Commercial                        |                     |                          |                   |  |                            |  |                            |
| Real estate                       | \$7,739,000         | \$7,739,000              | \$636,000         | \$7,126,000                                  | \$43,000                   | \$6,917,000                              | \$15,000                   |
| Construction                      | 792,000             | 792,000                  | -                 | 821,000                                      | -                          | 775,000                                  | -                          |
| Other                             | 1,940,000           | 1,940,000                | 352,000           | 1,801,000                                    | 16,000                     | 1,863,000                                | 6,000                      |
| Municipal                         | -                   | -                        | -                 | -  | -                          | -  | -                          |
| Residential                       |                     |                          |                   |  |                            |  |                            |
| Term                              | 16,067,000          | 16,067,000               | 398,000           | 14,852,000                                   | 187,000                    | 16,252,000                               | 63,000                     |
| Construction                      | 396,000             | 396,000                  | 82,000            | 1,358,000                                    | -                          | 410,000                                  | -                          |
| Home equity line of credit        | 1,234,000           | 1,234,000                | 95,000            | 865,000                                      | -                          | 1,248,000                                | -                          |
| Consumer                          | 102,000             | 102,000                  | 64,000            | 107,000                                      | -                          | 102,000                                  | -                          |
|                                   | \$28,270,000        | \$28,270,000             | \$1,627,000       | \$26,930,000                                 | \$246,000                  | \$27,567,000                             | \$84,000                   |



Note 4. Allowance for Loan Losses

The Company provides for loan losses through the establishment of an allowance for loan losses which represents an estimated reserve for existing losses in the loan portfolio. A systematic methodology is used for determining the allowance that includes a quarterly review process, risk rating changes, and adjustments to the allowance. The loan portfolio is classified in eight segments and credit risk is evaluated separately in each segment. The appropriate level of the allowance is evaluated continually based on a review of significant loans, with a particular emphasis on nonaccruing, past due, and other loans that may require special attention. Other factors include general conditions in local and national economies; loan portfolio composition and asset quality indicators; and internal factors such as changes in underwriting policies, credit administration practices, experience, ability and depth of lending management, among others. The allowance consists of four elements: (1) specific reserves for loans evaluated individually for impairment; (2) general reserves for each portfolio segment based on historical loan loss experience, (3) qualitative reserves judgmentally adjusted for local and national economic conditions, concentrations, portfolio composition, volume and severity of delinquencies and nonaccrual loans, trends of criticized and classified loans, changes in credit policies, and underwriting standards, credit administration practices, and other factors as applicable for each portfolio segment; and (4) unallocated reserves. All outstanding loans are considered in evaluating the appropriateness of the allowance. A breakdown of the allowance for loan losses as of September 30, 2012, December 31, 2011, and September 30, 2011, by class of financing receivable and allowance element, is presented in the following tables:

|                            | Specific<br>Reserves on<br>Loans<br>Evaluated<br>Individually<br>for<br>Impairment | General<br>Reserves<br>on Loans<br>Based on<br>Historical<br>Loss<br>Experience | Reserves<br>for<br>Qualitative<br>Factors | Unallocated<br>Reserves | Total<br>Reserves |
|----------------------------|--|---|---|-------------------------|-------------------|
| As of September 30, 2012   |  |   |   |                         |                   |
| Commercial                 |  |   |   |                         |                   |
| Real estate                | \$ 1,416,000   | \$ 2,479,000  | \$ 1,800,000                              | \$ -                    | \$ 5,695,000      |
| Construction               | 696,000  | 210,000   | 153,000                                   | -                       | 1,059,000         |
| Other                      | 1,240,000  | 807,000   | 585,000                                   | -                       | 2,632,000         |
| Municipal                  | -  | -   | 18,000                                    | -                       | 18,000            |
| Residential                |  |   |   |                         |                   |
| Term                       | 1,494,000  | 293,000   | 436,000                                   | -                       | 2,223,000         |
| Construction               | -  | 5,000   | 9,000                                     | -                       | 14,000            |
| Home equity line of credit | 215,000  | 238,000   | 337,000                                   | -                       | 790,000           |
| Consumer                   | 1,000  | 317,000   | 230,000                                   | -                       | 548,000           |
| Unallocated                | -  | -   | -   | 1,760,000               | 1,760,000         |
|                            | \$ 5,062,000   | \$ 4,349,000  | \$ 3,568,000                              | \$ 1,760,000            | \$ 14,739,000     |

|                         | Specific<br>Reserves on<br>Loans<br>Evaluated<br>Individually<br>for<br>Impairment | General<br>Reserves<br>on Loans<br>Based on<br>Historical<br>Loss<br>Experience | Reserves<br>for<br>Qualitative<br>Factors | Unallocated<br>Reserves | Total<br>Reserves |
|-------------------------|--|---|---|-------------------------|-------------------|
| As of December 31, 2011 |  |   |   |                         |                   |
| Commercial              |  |   |   |                         |                   |
| Real estate             | \$ 808,000   | \$ 2,578,000  | \$ 2,273,000                              | \$ -                    | \$ 5,659,000      |

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|                            |              |              |              |              |               |
|----------------------------|--------------|--------------|--------------|--------------|---------------|
| Construction               | 33,000       | 332,000      | 293,000      | -            | 658,000       |
| Other                      | 402,000      | 883,000      | 778,000      | -            | 2,063,000     |
| Municipal                  | -            | -            | 19,000       | -            | 19,000        |
| Residential                |              |              |              |              |               |
| Term                       | 478,000      | 222,000      | 459,000      | -            | 1,159,000     |
| Construction               | 235,000      | 6,000        | 14,000       | -            | 255,000       |
| Home equity line of credit | 91,000       | 149,000      | 355,000      | -            | 595,000       |
| Consumer                   | 11,000       | 331,000      | 242,000      | -            | 584,000       |
| Unallocated                | -            | -            | -            | 2,008,000    | 2,008,000     |
|                            | \$ 2,058,000 | \$ 4,501,000 | \$ 4,433,000 | \$ 2,008,000 | \$ 13,000,000 |

Page 17

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| As of September 30, 2011   | Specific Reserves on Loans Evaluated Individually for Impairment | General Reserves on Loans Based on Historical Loss Experience | Reserves for Qualitative Factors | Unallocated Reserves | Total Reserves |
|----------------------------|--|---|----------------------------------|----------------------|----------------|
| Commercial                 |  |   |                                  |                      |                |
| Real estate                | \$ 636,000   | \$2,547,000   | \$4,273,000                      | \$-                  | \$7,456,000    |
| Construction               | -  | 300,000   | 504,000                          | -                    | 804,000        |
| Other                      | 352,000  | 952,000   | 1,597,000                        | -                    | 2,901,000      |
| Municipal                  | -  | -   | 19,000                           | -                    | 19,000         |
| Residential                |  |   |                                  |                      |                |
| Term                       | 398,000  | 553,000   | 493,000                          | -                    | 1,444,000      |
| Construction               | 82,000   | 20,000  | 18,000                           | -                    | 120,000        |
| Home equity line of credit | 95,000   | 130,000   | 349,000                          | -                    | 574,000        |
| Consumer                   | 64,000   | 313,000   | 238,000                          | -                    | 615,000        |
| Unallocated                | -  | -   | -                                | 1,386,000            | 1,386,000      |
|                            | \$ 1,627,000   | \$4,815,000   | \$7,491,000                      | \$1,386,000          | \$15,319,000   |

Qualitative adjustment factors are taken into consideration when determining reserve estimates. These adjustment factors are based upon our evaluation of various current conditions, including those listed below.

General economic conditions.

- Credit quality trends with emphasis on loan delinquencies, nonaccrual levels and classified loans.

Recent loss experience in particular segments of the portfolio.

Loan volumes and concentrations, including changes in mix.

Other factors, including changes in quality of the loan origination; loan policy changes; changes in credit risk management processes; Bank regulatory and external loan review examination results.

The qualitative amount assigned to the substandard commercial loan segments was reduced at September 30, 2012 from June 30, 2012 to adjust historical loss averages for the impact of recent write downs taken on a large, atypical credit. Changes to qualitative adjustments for other major portfolio segments were not material at September 30, 2012. The unallocated component of the Allowance for Loan Losses totaled \$1.8 million at September 30, 2012. This compares to \$1.9 million as of June 30, 2012 and \$2.0 million as of December 31, 2011. Management views these fluctuations in the unallocated portion of the Allowance for Loan Losses to be immaterial. The unallocated amount was deemed appropriate due to the following:

In general, the unallocated component is available to cover imprecision or uncertainties to incorporate the range of probable outcomes inherent in estimates used for the allowance, which may change from period to period. An example of this could be a delay in receiving an updated appraisal on a troubled credit.

An internal analysis completed on foreclosed property found that when these properties are sold, on average, the selling price is approximately 22% below the appraised value of the property at the time of take in. The unallocated provides for uncertainty in the value of properties when in impaired loan status.

Watch-rated commercial loans have increased after bottoming out in late 2009 and early 2010. Additional losses may exist in this portfolio segment, yet are not identifiable at present. The unallocated portion provides some level of support for this.

Commercial loans are comprised of three major classes, commercial real estate loans, commercial construction loans and other commercial loans. Commercial real estate is primarily comprised of loans to small businesses collateralized by owner-occupied real estate, while other commercial is primarily comprised of loans to small businesses collateralized by plant and equipment, commercial fishing vessels and gear, and limited inventory-based



lending. Commercial real estate loans typically have a maximum loan-to-value of 75% based upon current appraisal information at the time the loan is made. Municipal loans are comprised of loans to municipalities in Maine for capitalized expenditures, construction projects or tax-anticipation notes. All municipal loans are considered general obligations of the municipality and as such are collateralized by the taxing ability of the municipality for repayment of debt.

Construction loans, both commercial and residential, comprise a very small portion of the portfolio, and at 21.7% of capital are well under the regulatory guidance of 100.0% of capital at September 30, 2012. Construction loans and non-owner-occupied commercial real estate loans are at 79.0% of total capital, well under regulatory guidance of 300.0% of capital at September 30, 2012.

The process of establishing the allowance with respect to the commercial loan portfolio begins when a loan officer initially assigns each loan a risk rating, using established credit criteria. Approximately 50% of the outstanding loans

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and commitments are subject to review and validation annually by an independent consulting firm, as well as periodically by the Company's internal credit review function. The methodology employs Management's judgment as to the level of losses on existing loans based on internal review of the loan portfolio, including an analysis of a borrower's current financial position, and the consideration of current and anticipated economic conditions and their potential effects on specific borrowers and or lines of business. In determining the Company's ability to collect certain loans, Management also considers the fair value of underlying collateral. The risk rating system has eight levels, defined as follows:

1 Strong

Credits rated "1" are characterized by borrowers fully responsible for the credit with excellent capacity to pay principal and interest. Loans rated "1" may be secured with acceptable forms of liquid collateral.

2 Above Average

Credits rated "2" are characterized by borrowers that have better than average liquidity, capitalization, earnings and/or cash flow with a consistent record of solid financial performance.

3 Satisfactory

Credits rated "3" are characterized by borrowers with favorable liquidity, profitability and financial condition with adequate cash flow to pay debt service.

4 Average

Credits rated "4" are characterized by borrowers that present risk more than 1, 2 and 3 rated loans and merit an ordinary level of ongoing monitoring. Financial condition is on par or somewhat below industry averages while cash flow is generally adequate to meet debt service requirements.

5 Watch

Credits rated "5" are characterized by borrowers that warrant greater monitoring due to financial condition or unresolved and identified risk factors.

6 Other Assets Especially Mentioned (OAEM)

Loans in this category are currently protected but are potentially weak and constitute an undue and unwarranted credit risk, but not to the point of justifying a classification of substandard. OAEM have potential weaknesses which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date.

7 Substandard

Loans in this category are inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard loans are characterized by the distinct possibility that the Bank may sustain some loss if the deficiencies are not corrected.

8 Doubtful

Loans classified "Doubtful" have the same weaknesses as those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is high, but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status may be determined.

The following table summarizes the risk ratings for the Company's commercial real estate, commercial construction, commercial other, and municipal loans as of September 30, 2012:

|                 | Commercial<br>Real Estate | Commercial<br>Construction | Commercial<br>Other | Municipal<br>Loans | All Risk-<br>Rated Loans |
|-----------------|---------------------------|----------------------------|---------------------|--------------------|--------------------------|
| 1 Strong        | \$20,000                  | \$-                        | \$279,000           | \$1,775,000        | \$2,074,000              |
| 2 Above Average | 18,918,000                | 699,000                    | 5,426,000           | 8,651,000          | 33,694,000               |
| 3 Satisfactory  | 36,580,000                | 643,000                    | 13,497,000          | 3,523,000          | 54,243,000               |
| 4 Average       | 105,150,000               | 10,670,000                 | 30,688,000          | 2,499,000          | 149,007,000              |
| 5 Watch         | 39,494,000                | 1,812,000                  | 19,100,000          | -                  | 60,406,000               |

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|               |               |              |              |              |               |
|---------------|---------------|--------------|--------------|--------------|---------------|
| 6 OAEM        | 21,530,000    | 1,227,000    | 3,731,000    | -            | 26,488,000    |
| 7 Substandard | 34,359,000    | 6,854,000    | 10,916,000   | -            | 52,129,000    |
| 8 Doubtful    | 480,000       | -            | 66,000       | -            | 546,000       |
| Total         | \$256,531,000 | \$21,905,000 | \$83,703,000 | \$16,448,000 | \$378,587,000 |

Page 19

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The following table summarizes the risk ratings for the Company's commercial real estate, commercial construction, commercial other, and municipal loans as of December 31, 2011:

|                 | Commercial<br>Real Estate | Commercial<br>Construction | Commercial<br>Other | Municipal<br>Loans | All Risk-<br>Rated Loans |
|-----------------|---------------------------|----------------------------|---------------------|--------------------|--------------------------|
| 1 Strong        | \$23,000                  | \$-                        | \$465,000           | \$2,158,000        | \$2,646,000              |
| 2 Above Average | 21,334,000                | -                          | 4,229,000           | 7,509,000          | 33,072,000               |
| 3 Satisfactory  | 33,119,000                | 1,365,000                  | 10,981,000          | 3,861,000          | 49,326,000               |
| 4 Average       | 106,171,000               | 17,125,000                 | 31,600,000          | 2,693,000          | 157,589,000              |
| 5 Watch         | 44,215,000                | 3,287,000                  | 17,893,000          | -                  | 65,395,000               |
| 6 OAEM          | 18,309,000                | 2,320,000                  | 5,303,000           | -                  | 25,932,000               |
| 7 Substandard   | 31,575,000                | 7,323,000                  | 16,362,000          | -                  | 55,260,000               |
| 8 Doubtful      | 678,000                   | 1,154,000                  | 149,000             | -                  | 1,981,000                |
| Total           | \$255,424,000             | \$32,574,000               | \$86,982,000        | \$16,221,000       | \$391,201,000            |

The following table summarizes the risk ratings for the Company's commercial real estate, commercial construction, commercial other, and municipal loans as of September 30, 2011:

|                 | Commercial<br>Real Estate | Commercial<br>Construction | Commercial<br>Other | Municipal<br>Loans | All Risk-<br>Rated Loans |
|-----------------|---------------------------|----------------------------|---------------------|--------------------|--------------------------|
| 1 Strong        | \$28,000                  | \$-                        | \$351,000           | \$2,214,000        | \$2,593,000              |
| 2 Above Average | 20,546,000                | 10,000                     | 3,444,000           | 10,930,000         | 34,930,000               |
| 3 Satisfactory  | 36,693,000                | 1,665,000                  | 14,408,000          | 3,896,000          | 56,662,000               |
| 4 Average       | 113,350,000               | 14,564,000                 | 35,808,000          | 2,813,000          | 166,535,000              |
| 5 Watch         | 40,518,000                | 5,222,000                  | 15,235,000          | -                  | 60,975,000               |
| 6 OAEM          | 14,964,000                | 4,007,000                  | 4,522,000           | -                  | 23,493,000               |
| 7 Substandard   | 31,811,000                | 4,877,000                  | 22,271,000          | -                  | 58,959,000               |
| 8 Doubtful      | -                         | -                          | 6,000               | -                  | 6,000                    |
| Total           | \$257,910,000             | \$30,345,000               | \$96,045,000        | \$19,853,000       | \$404,153,000            |

Commercial loans are generally charged off when all or a portion of the principal amount is determined to be uncollectible. This determination is based on circumstances specific to a borrower including repayment ability, analysis of collateral and other factors as applicable.

Residential loans are comprised of two classes: term loans, which include traditional amortizing home mortgages, and construction loans, which include loans for owner-occupied residential construction. Residential loans typically have a 75% to 80% loan to value based upon current appraisal information at the time the loan is made. Home equity loans and lines of credit are typically written to the same underwriting standards. Consumer loans are primarily amortizing loans to individuals collateralized by automobiles, pleasure craft and recreation vehicles, typically with a maximum loan to value of 80% to 90% of the purchase price of the collateral. Consumer loans also include a small amount of unsecured short-term time notes to individuals.

Residential loans, consumer loans and home equity lines of credit are segregated into homogeneous pools with similar risk characteristics. Trends and current conditions are analyzed and historical loss experience is adjusted accordingly. Quantitative and qualitative adjustment factors for these segments are consistent with those for the commercial and municipal classes. Certain loans in the residential, home equity lines of credit and consumer classes identified as having the potential for further deterioration are analyzed individually to confirm impairment status, and to determine the need for a specific reserve, however there is no formal rating system used for these classes. Consumer loans greater than 120 days past due are generally charged off. Residential loans 90 days or more past due are placed on non-accrual status unless the loans are both well secured and in the process of collection.

There were no changes to the Company's accounting policies or methodology used to estimate the allowance for loan losses during the nine months ended September 30, 2012.

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The following table presents allowance for loan losses activity by class for the nine-months and quarter ended September 30, 2012, and allowance for loan loss balances by class and related loan balances by class as of September 30, 2012:

|  | Commercial<br>Real Estate | Construction | Other        | Municipal    | Residential<br>Term | Construction | Home Equity<br>Line of Credit | Consum       |
|--|---------------------------|--------------|--------------|--------------|---------------------|--------------|-------------------------------|--------------|
| For the nine months ended September 30, 2012       |                           |              |              |              |                     |              |                               |              |
| Beginning  |                           |              |              |              |                     |              |                               |              |
| balance  | \$5,659,000               | \$658,000    | \$2,063,000  | \$19,000     | \$1,159,000         | \$255,000    | \$595,000                     | \$584,000    |
| Charge offs  | 1,101,000                 | 87,000       | 2,168,000    | -            | 554,000             | 381,000      | 391,000                       | 382,000      |
| Recoveries   | 4,000                     | 247,000      | 50,000       | -            | 3,000               | 42,000       | -                             | 157,000      |
| Provision  | 1,133,000                 | 241,000      | 2,687,000    | (1,000)      | 1,615,000           | 98,000       | 586,000                       | 189,000      |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  | \$5,695,000               | \$1,059,000  | \$2,632,000  | \$18,000     | \$2,223,000         | \$14,000     | \$790,000                     | \$548,000    |
| For the three months ended September 30, 2012      |                           |              |              |              |                     |              |                               |              |
| Beginning  |                           |              |              |              |                     |              |                               |              |
| balance  | \$5,564,000               | \$1,373,000  | \$2,476,000  | \$19,000     | \$1,587,000         | \$58,000     | \$809,000                     | \$603,000    |
| Charge offs  | 186,000                   | 87,000       | 6,000        | -            | 179,000             | 263,000      | 342,000                       | 106,000      |
| Recoveries   | 3,000                     | 1,000        | 39,000       | -            | 1,000               | 42,000       | -                             | 38,000       |
| Provision  | 314,000                   | (228,000)    | 123,000      | (1,000)      | 814,000             | 177,000      | 323,000                       | 13,000       |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  | \$5,695,000               | \$1,059,000  | \$2,632,000  | \$18,000     | \$2,223,000         | \$14,000     | \$790,000                     | \$548,000    |
| Allowance for loan losses as of September 30, 2012 |                           |              |              |              |                     |              |                               |              |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  |                           |              |              |              |                     |              |                               |              |
| specifically                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |
| impairment   | \$1,416,000               | \$696,000    | \$1,240,000  | \$-          | \$1,494,000         | \$-          | \$215,000                     | \$1,000      |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  |                           |              |              |              |                     |              |                               |              |
| collectively                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |
| impairment   | \$4,279,000               | \$363,000    | \$1,392,000  | \$18,000     | \$729,000           | \$14,000     | \$575,000                     | \$547,000    |
| Related loan balances as of September 30, 2012     |                           |              |              |              |                     |              |                               |              |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  | \$256,531,000             | \$21,905,000 | \$83,703,000 | \$16,448,000 | \$369,949,000       | \$6,528,000  | \$100,099,000                 | \$14,708,000 |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  |                           |              |              |              |                     |              |                               |              |
| specifically                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |
| impairment   | \$16,321,000              | \$6,645,000  | \$4,905,000  | \$-          | \$19,305,000        | \$23,000     | \$1,445,000                   | \$1,000      |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  |                           |              |              |              |                     |              |                               |              |
| collectively                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |
| impairment   | \$240,210,000             | \$15,260,000 | \$78,798,000 | \$16,448,000 | \$350,644,000       | \$6,505,000  | \$98,654,000                  | \$14,707,000 |

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The following table presents allowance for loan loss balances by class and related loan balances by class as of December 31, 2011:

|  | Commercial<br>Real Estate | Construction  | Other         | Municipal     | Residential<br>Term | Construction  | Home Equity<br>Line of Credit | Consum        |
|--|---------------------------|---------------|---------------|---------------|---------------------|---------------|-------------------------------|---------------|
| Allowance for loan losses as of December 31, 2011    |                           |               |               |               |                     |               |                               |               |
| Ending balance specifically evaluated for impairment | \$ 808,000                | \$ 33,000     | \$ 402,000    | \$ -          | \$ 478,000          | \$ 235,000    | \$ 91,000                     | \$ 11,000     |
| Ending balance collectively evaluated for impairment | \$ 4,851,000              | \$ 625,000    | \$ 1,661,000  | \$ 19,000     | \$ 681,000          | \$ 20,000     | \$ 504,000                    | \$ 573,000    |
| Related loan balances as of December 31, 2011        |                           |               |               |               |                     |               |                               |               |
| Ending balance                                       | \$ 255,424,000            | \$ 32,574,000 | \$ 86,982,000 | \$ 16,221,000 | \$ 341,286,000      | \$ 10,469,000 | \$ 105,244,000                | \$ 16,780,000 |
| Ending balance specifically evaluated for impairment | \$ 10,141,000             | \$ 5,702,000  | \$ 7,042,000  | \$ -          | \$ 16,821,000       | \$ 1,198,000  | \$ 1,163,000                  | \$ 53,000     |
| Ending balance collectively evaluated for impairment | \$ 245,283,000            | \$ 26,872,000 | \$ 79,940,000 | \$ 16,221,000 | \$ 324,465,000      | \$ 9,271,000  | \$ 104,081,000                | \$ 16,730,000 |

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The following table presents allowance for loan losses activity by class for the nine-months and quarter ended September 30, 2011, and allowance for loan loss balances by class and related loan balances by class as of September 30, 2011:

|  | Commercial<br>Real Estate | Construction | Other        | Municipal    | Residential<br>Term | Construction | Home Equity<br>Line of Credit | Consumer     |
|--|---------------------------|--------------|--------------|--------------|---------------------|--------------|-------------------------------|--------------|
| For the nine months ended September 30, 2011       |                           |              |              |              |                     |              |                               |              |
| Beginning  |                           |              |              |              |                     |              |                               |              |
| balance  | \$5,260,000               | \$1,012,000  | \$2,377,000  | \$19,000     | \$1,408,000         | \$44,000     | \$670,000                     | \$646,000    |
| Charge offs  | 835,000                   | -            | 942,000      | -            | 1,013,000           | 505,000      | 240,000                       | 298,000      |
| Recoveries   | 8,000                     | -            | 33,000       | -            | 5,000               | -            | 1,000                         | 189,000      |
| Provision  | 3,023,000                 | (208,000)    | 1,433,000    | -            | 1,044,000           | 581,000      | 143,000                       | 78,000       |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  | \$7,456,000               | \$804,000    | \$2,901,000  | \$19,000     | \$1,444,000         | \$120,000    | \$574,000                     | \$615,000    |
| For the three months ended September 30, 2011      |                           |              |              |              |                     |              |                               |              |
| Beginning  |                           |              |              |              |                     |              |                               |              |
| balance  | \$6,927,000               | \$702,000    | \$3,323,000  | \$19,000     | \$1,356,000         | \$35,000     | \$652,000                     | \$664,000    |
| Charge offs  | -                         | -            | 623,000      | -            | 316,000             | -            | 195,000                       | 142,000      |
| Recoveries   | 3,000                     | -            | 12,000       | -            | 1,000               | -            | -                             | 43,000       |
| Provision  | 526,000                   | 102,000      | 189,000      | -            | 403,000             | 85,000       | 117,000                       | 50,000       |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  | \$7,456,000               | \$804,000    | \$2,901,000  | \$19,000     | \$1,444,000         | \$120,000    | \$574,000                     | \$615,000    |
| Allowance for loan losses as of September 30, 2011 |                           |              |              |              |                     |              |                               |              |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  |                           |              |              |              |                     |              |                               |              |
| specifically                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |
| impairment   | \$636,000                 | \$-          | \$352,000    | \$-          | \$398,000           | \$82,000     | \$95,000                      | \$64,000     |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  |                           |              |              |              |                     |              |                               |              |
| collectively                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |
| impairment   | \$6,820,000               | \$804,000    | \$2,549,000  | \$19,000     | \$1,046,000         | \$38,000     | \$479,000                     | \$551,000    |
| Related loan balances as of September 30, 2011     |                           |              |              |              |                     |              |                               |              |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  | \$257,910,000             | \$30,345,000 | \$96,045,000 | \$19,853,000 | \$329,730,000       | \$12,061,000 | \$105,891,000                 | \$16,730,000 |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  |                           |              |              |              |                     |              |                               |              |
| specifically                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |
| impairment   | \$7,739,000               | \$792,000    | \$1,940,000  | \$-          | \$16,067,000        | \$396,000    | \$1,234,000                   | \$102,000    |
| Ending   |                           |              |              |              |                     |              |                               |              |
| balance  | \$250,171,000             | \$29,553,000 | \$94,105,000 | \$19,853,000 | \$313,663,000       | \$11,665,000 | \$104,657,000                 | \$16,630,000 |
| collectively                                       |                           |              |              |              |                     |              |                               |              |
| evaluated  |                           |              |              |              |                     |              |                               |              |
| for  |                           |              |              |              |                     |              |                               |              |





### Troubled Debt Restructured

A troubled debt restructured ("TDR") constitutes a restructuring of debt if the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. To determine whether or not a loan should be classified as a TDR, Management evaluates a loan based upon the following criteria:

The borrower demonstrates financial difficulty; common indicators include past due status with bank obligations, substandard credit bureau reports, or an inability to refinance with another lender, and

The Company has granted a concession; common concession types include maturity date extension, interest rate adjustments to below market pricing, and deferment of payments.

As of September 30, 2012, the Company had 91 loans with a value of \$29,349,000 that have been classified as TDRs. This compares to 59 loans with a value of \$22,858,000 and 45 loans with a value of \$10,467,000 classified as TDRs as of December 31, 2011 and September 30, 2011, respectively. The impairment carried as a specific reserve in the allowance for loan losses is calculated by present valuing the cashflow modification on the loan, or, for collateral-dependent loans, using the fair value of the collateral less costs to sell. The following table shows TDRs by class and the specific reserve as of September 30, 2012:

|                            | Number<br>of<br>Loans | Balance      | Specific<br>Reserves |
|----------------------------|-----------------------|--------------|----------------------|
| Commercial                 |                       |              |                      |
| Real estate                | 18                    | \$12,329,000 | \$823,000            |
| Construction               | 2                     | 3,099,000    | 696,000              |
| Other                      | 20                    | 2,614,000    | 594,000              |
| Municipal                  | -                     | -            | -                    |
| Residential                |                       |              |                      |
| Term                       | 50                    | 10,890,000   | 371,000              |
| Construction               | -                     | -            | -                    |
| Home equity line of credit | 1                     | 417,000      | -                    |
| Consumer                   | -                     | -            | -                    |
|                            | 91                    | \$29,349,000 | \$2,484,000          |

As of September 30, 2012, 15 of the loans classified as TDRs with a total balance of \$2,820,000 were more than 30 days past due. Of these loans, six loans with an outstanding balance of \$970,000 had been placed on TDR status in the previous 12 months. The following table shows these TDRs by class and the associated specific reserves included in the allowance for loan losses as of September 30, 2012:

|                            | Number<br>of<br>Loans | Balance   | Specific<br>Reserves |
|----------------------------|-----------------------|-----------|----------------------|
| Commercial                 |                       |           |                      |
| Real estate                | 1                     | \$263,000 | \$-                  |
| Construction               | -                     | -         | -                    |
| Other                      | 2                     | 55,000    | 22,000               |
| Municipal                  | -                     | -         | -                    |
| Residential                |                       |           |                      |
| Term                       | 12                    | 2,502,000 | 148,000              |
| Construction               | -                     | -         | -                    |
| Home equity line of credit | -                     | -         | -                    |
| Consumer                   | -                     | -         | -                    |

15      \$2,820,000    \$170,000

For the nine months ended September 30, 2012, 38 loans were placed on TDR status with an outstanding balance of \$12,369,000. These were considered TDRs because concessions had been granted to borrowers experiencing financial difficulties. Concessions include reductions in interest rates, principal and/or interest forbearance, payment extensions, or combinations thereof.

The following table shows loans placed on TDR status in the nine months ended September 30, 2012, by class of loan and the associated specific reserve included in the allowance for loan losses as of September 30, 2012:

|                            | Number<br>of<br>Loans | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Specific<br>Reserves |
|----------------------------|-----------------------|---|--|----------------------|
| Commercial                 |                       |   |  |                      |
| Real estate                | 13                    | \$ 6,962,000  | \$ 7,171,000   | \$ 175,000           |
| Construction               | 1                     | 1,951,000   | 1,951,000  | 696,000              |
| Other                      | 14                    | 1,369,000   | 1,380,000  | 546,000              |
| Municipal                  | -                     | -   | -  | -                    |
| Residential                |                       |   |  |                      |
| Term                       | 9                     | 1,670,000   | 1,672,000  | 84,000               |
| Construction               | -                     | -   | -  | -                    |
| Home equity line of credit | 1                     | 417,000   | 417,000  | -                    |
| Consumer                   | -                     | -   | -  | -                    |
|                            | 38                    | \$ 12,369,000   | \$ 12,591,000  | \$ 1,501,000         |

For the quarter ended September 30, 2012, 11 loans were placed on TDR status with an outstanding balance of \$4,512,000. These were considered to be TDRs because concessions had been granted to borrowers experiencing financial difficulties. Concessions include reductions in interest rates, principal and/or interest forbearance, payment extensions, or combinations thereof. The following table shows loans placed on TDR status in the quarter ended September 30, 2012, by class of loan and the associated specific reserve included in the allowance for loan losses as of September 30, 2012:

|                            | Number<br>of<br>Loans | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Specific<br>Reserves |
|----------------------------|-----------------------|---|--|----------------------|
| Commercial                 |                       |   |  |                      |
| Real estate                | 2                     | \$ 3,150,000  | \$ 3,150,000   | \$ 29,000            |
| Construction               | -                     | -   | -  | -                    |
| Other                      | 6                     | 682,000   | 682,000  | 2,000                |
| Municipal                  | -                     | -   | -  | -                    |
| Residential                |                       |   |  |                      |
| Term                       | 2                     | 263,000   | 264,000  | 15,000               |
| Construction               | -                     | -   | -  | -                    |
| Home equity line of credit | 1                     | 417,000   | 417,000  | -                    |
| Consumer                   | -                     | -   | -  | -                    |
|                            | 11                    | \$ 4,512,000  | \$ 4,513,000   | \$ 46,000            |

As of September 30, 2012, Management is aware of four loans classified as TDRs that are involved in bankruptcy with an outstanding balance of \$712,000. There were also 29 loans with an outstanding balance of \$4,276,000 that

were classified as TDRs and on non-accrual status, four of which, with an outstanding balance of \$574,000, were in the process of foreclosure.

## Note 5 – Stock Options and Stock-Based Compensation

At the 2010 Annual Meeting, shareholders approved the 2010 Equity Incentive Plan (the "2010 Plan"). This reserves 400,000 shares of common stock for issuance in connection with stock options, restricted stock awards and other equity based awards to attract and retain the best available personnel, provide additional incentive to officers, employees and non-employee Directors and promote the success of our business. Such grants and awards will be structured in a manner that does not encourage the recipients to expose the Company to undue or inappropriate risk. Options issued under the 2010 Plan will qualify for treatment as incentive stock options for purposes of Section 422 of the Internal Revenue Code. Other compensation under the 2010 Plan will qualify as performance-based for purposes of Section 162(m) of the Internal Revenue Code, and will satisfy NASDAQ guidelines relating to equity compensation.

As of September 30, 2012, 19,727 shares of restricted stock had been granted under the 2010 Plan, as detailed in the following table:

| Year    | Vesting Term | Shares | Remaining Term |
|---------|--------------|--------|----------------|
| Granted | (In Years)   |        | (In Years)     |
| 2011    | 4.0          | 1,500  | 2.3            |
| 2011    | 5.0          | 5,500  | 3.3            |
| 2012    | 3.0          | 2,027  | 2.4            |
| 2012    | 4.0          | 2,704  | 3.4            |
| 2012    | 5.0          | 7,996  | 4.4            |
|         |              | 19,727 | 3.6            |

The compensation cost related to these restricted stock grants was \$302,000 and will be recognized over the vesting terms of each grant. In the first nine months of 2012, \$57,000 of expense was recognized for these restricted shares, leaving \$223,000 in unrecognized expense as of September 30, 2012. In the first nine months of 2011, \$17,000 of expense was recognized for restricted shares, leaving \$94,000 in unrecognized expense as of September 30, 2011. The Company established a shareholder-approved stock option plan in 1995 (the "1995 Plan"), under which the Company granted options to employees for 600,000 shares of common stock. Only incentive stock options were granted under the 1995 Plan. The option price of each option grant was determined by the Options Committee of the Board of Directors, and in no instance was less than the fair market value on the date of the grant. An option's maximum term was ten years from the date of grant, with 50% of the options granted vesting two years from the date of grant and the remaining 50% vesting five years from the date of grant. As of January 16, 2005, all options under the 1995 Plan had been granted.

The Company applies the fair value recognition provisions of the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 718 "Compensation – Stock Compensation", to stock-based employee compensation. As of September 30, 2012, all outstanding options were fully vested and all compensation cost for options had been recognized. A summary of the status of outstanding stock options as of September 30, 2012 and changes during the nine-month period then ended, is presented below.

|                                  | Number | Weighted | Weighted    | Aggregate  |
|----------------------------------|--------|----------|-------------|------------|
|                                  | of     | Average  | Remaining   | Intrinsic  |
|                                  | Shares | Exercise | Contractual | Value      |
|                                  |        | Price    | Term (In    | (In        |
|                                  |        |          | years)      | thousands) |
| Outstanding at December 31, 2011 | 51,000 | \$ 16.47 |             |            |
| Granted in 2012                  | -      | -        |             |            |

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|                                   |          |          |     |           |
|-----------------------------------|----------|----------|-----|-----------|
| Exercised in 2012                 | (9,000 ) | \$ 9.33  |     | \$ 59,000 |
| Forfeited in 2012                 | -        | -        |     |           |
| Outstanding at September 30, 2012 | 42,000   | \$ 18.00 | 2.3 | -         |
| Exercisable at September 30, 2012 | 42,000   | \$ 18.00 | 2.3 | -         |

Page 25

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## Note 6 – Preferred and Common Stock

### Preferred Stock

On January 9, 2009, the Company issued \$25 million in Fixed Rate Cumulative Perpetual Preferred Stock, Series A, having a liquidation preference of \$1,000 per share, to the U.S. Treasury under the Capital Purchase Program ("the CPP Shares"). The CPP Shares call for cumulative dividends at a rate of 5.0% per year for the first five years, and at a rate of 9.0% per year in following years, payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year.

On August 24, 2011, the Company repurchased \$12.5 million of the CPP Shares. The repurchase transaction was approved by the Federal Reserve Bank of Boston, the Company's primary regulator, as well as the Bank's primary regulator, the Office of the Comptroller of the Currency, based on continued strong capital ratios after the repayment. Almost all of the repayment was made from retained earnings accumulated since the preferred stock was issued in 2009. After the repurchase, \$12.5 million of the CPP shares remains outstanding. The Company may redeem the remaining CPP Shares at any time using any funds available, subject to the prior approval of the Federal Reserve Bank of Boston. The CPP Shares are "perpetual" preferred stock, which means that neither Treasury nor any subsequent holder would have a right to require that the Company redeem any of the shares.

Incident to such issuance, the Company issued to the U.S. Treasury warrants (the "Warrants") to purchase up to 225,904 shares of the Company's common stock at a price per share of \$16.60 (subject to adjustment). The CPP Shares and the related Warrants (and any shares of common stock issuable pursuant to the Warrants) are freely transferable by Treasury to third parties and the Company has filed a registration statement with the Securities and Exchange Commission to allow for possible resale of such securities. The CPP Shares qualify as Tier 1 capital on the Company's books for regulatory purposes and rank senior to the Company's common stock and senior or at an equal level in the Company's capital structure to any other shares of preferred stock the Company may issue in the future. The Warrants issued in conjunction with the sale of the CPP Shares have a term of ten years and could be exercised by Treasury or a subsequent holder at any time or from time to time during their term. To the extent they had not previously been exercised, the Warrants would expire after ten years. Treasury will not vote any shares of common stock it receives upon exercise of the Warrants, but that restriction would not apply to third parties to whom Treasury transferred the Warrants. The Warrants (and any common stock issued upon exercise of the Warrants) could be transferred to third parties separately from the CPP Shares. The proceeds from the sale of the CPP Shares were allocated between the CPP Shares and Warrants based on their relative fair values on the issue date. The fair value of the Warrants was determined using the Black-Scholes model which includes the following assumptions: common stock price of \$16.60 per share, dividend yield of 4.70%, stock price volatility of 24.43%, and a risk-free interest rate of 2.01%. The discount on the CPP Shares was based on the value that was allocated to the Warrants upon issuance, and is being accreted back to the value of the CPP Shares over a five-year period (the expected life of the shares upon issuance) on a straight-line basis. The Warrants were unchanged as a result of the CPP Shares repurchase transaction and remain outstanding.

As a condition to Treasury's purchase of the CPP Shares, during the time that Treasury holds any equity or debt instrument the Company issued, the Company is required to comply with certain restrictions and other requirements relating to the compensation of the Company's chief executive officer, chief financial officer and three other most highly compensated executive officers. These restrictions include a prohibition on severance payments to those executive officers upon termination of their employment and a \$500,000 limit on the tax deductions the Company can take for compensation expense for each of those executive officers in a single year as well as a prohibition on bonus compensation to such officers other than limited amounts of long-term restricted stock.

### Common Stock

As a consequence of the Company's issuance of securities under the U.S. Treasury's Capital Purchase Program, its ability to repurchase stock while such securities remain outstanding is restricted to purchases from employee benefit plans. In the first nine months of 2012, the Company repurchased no common stock.





## Note 7 – Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share (EPS) for the nine months ended September 30, 2012 and 2011:

|  | Income<br>(Numerator) | Shares<br>(Denominator) | Per-Share<br>Amount |
|--|-----------------------|-------------------------|---------------------|
| For the nine months ended September 30, 2012                                   |                       |                         |                     |
| Net income as reported   | \$9,459,000           |                         |                     |
| Less dividends and amortization of premium on preferred stock                  | 543,000               |                         |                     |
| Basic EPS: Income available to common shareholders                             | 8,916,000             | 9,825,719               | \$ 0.91             |
| Effect of dilutive securities: restricted stock                                |                       | 16,894                  |                     |
| Diluted EPS: Income available to common shareholders plus assumed conversions  | \$8,916,000           | 9,842,613               | \$ 0.91             |
| For the nine months ended September 30, 2011                                   |                       |                         |                     |
| Net income as reported   | \$9,341,000           |                         |                     |
| Less dividends and amortization of premium on preferred stock                  | 1,027,000             |                         |                     |
| Basic EPS: Income available to common shareholders                             | 8,314,000             | 9,785,063               | \$ 0.85             |
| Effect of dilutive securities:<br>incentive stock options and restricted stock |                       | 10,888                  |                     |
| Diluted EPS: Income available to common shareholders plus assumed conversions  | \$8,314,000           | 9,795,951               | \$ 0.85             |

The following table sets forth the computation of basic and diluted EPS for the quarters ended September 30, 2012 and 2011:

|  | Income<br>(Numerator) | Shares<br>(Denominator) | Per-Share<br>Amount |
|--|-----------------------|-------------------------|---------------------|
| For the quarter ended September 30, 2012                                       |                       |                         |                     |
| Net income as reported   | \$3,223,000           |                         |                     |
| Less dividends and amortization of premium on preferred stock                  | 181,000               |                         |                     |
| Basic EPS: Income available to common shareholders                             | 3,042,000             | 9,824,568               | \$ 0.31             |
| Effect of dilutive securities: restricted stock and warrants                   |                       | 22,814                  |                     |
| Diluted EPS: Income available to common shareholders plus assumed conversions  | \$3,042,000           | 9,847,382               | \$ 0.31             |
| For the quarter ended September 30, 2011                                       |                       |                         |                     |
| Net income as reported   | \$3,006,000           |                         |                     |
| Less dividends and amortization of premium on preferred stock                  | 353,000               |                         |                     |
| Basic EPS: Income available to common shareholders                             | 2,653,000             | 9,791,550               | \$ 0.27             |
| Effect of dilutive securities:<br>incentive stock options and restricted stock |                       | 11,843                  |                     |
| Diluted EPS: Income available to common shareholders plus assumed conversions  | \$2,653,000           | 9,803,393               | \$ 0.27             |

All earnings per share calculations have been made using the weighted average number of shares outstanding during the period. The potentially dilutive securities are incentive stock options and unvested shares of restricted stock granted to certain key members of Management and warrants granted to the U.S. Treasury under the CPP. The number of dilutive shares is calculated using the treasury method, assuming that all options and warrants were exercisable at

the end of each period. Options and warrants that are out-of-the-money are not considered in the calculation of dilutive earnings per share as the effect would be anti-dilutive.

Page 27

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The following table presents the number of options and warrants outstanding as of September 30, 2012 and 2011 and the amount for which the market price at period end is above or below the strike price:

|                                  | Outstanding  |                  |         |
|----------------------------------|--------------|------------------|---------|
|                                  | In-the-Money | Out-of-the-Money |         |
| As of September 30, 2012         |              |                  |         |
| Incentive stock options          | 42,000       | -                | 42,000  |
| Warrants issued to U.S. Treasury | 225,904      | 225,904          | -       |
| Total dilutive securities        | 267,904      | 225,904          | 42,000  |
| As of September 30, 2011         |              |                  |         |
| Incentive stock options          | 55,500       | 13,500           | 42,000  |
| Warrants issued to U.S. Treasury | 225,904      | -                | 225,904 |
| Total dilutive securities        | 281,404      | 13,500           | 267,904 |

#### Note 8 – Employee Benefit Plans

##### 401(k) Plan

The Bank has a defined contribution plan available to substantially all employees who have completed 3 months of service. Employees may contribute up to IRS determined limits and the Bank may match employee contributions not to exceed 3.0% of compensation depending on contribution level. Subject to a vote of the Board of Directors, the Bank may also make a profit-sharing contribution to the Plan. Such contribution equaled 2.0% of each eligible employee's compensation in 2011. The amount for 2012 has not been established. The expense related to the 401(k) plan was \$272,000 and \$302,000 for the nine months ended September 30, 2012 and 2011, respectively.

##### Supplemental Retirement Benefits

The Bank also provides unfunded, non-qualified supplemental retirement benefits for certain officers, payable in installments over 20 years upon retirement or death. The agreements consist of individual contracts with differing characteristics that, when taken together, do not constitute a postretirement plan. The costs for these benefits are recognized over the service periods of the participating officers in accordance with FASB ASC Topic 712 "Compensation – Nonretirement Postemployment Benefits". The expense of these supplemental retirement benefits was \$217,000 and \$232,000 for the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012, the associated accrued liability included in other liabilities in the balance sheet was \$2,022,000 compared to \$1,847,000 and \$1,787,000 at December 31, 2011 and September 30, 2011, respectively.

##### Post-Retirement Benefit Plans

The Bank sponsors two post-retirement benefit plans. One plan currently provides a subsidy for health insurance premiums to certain retired employees and a future subsidy for seven active employees who were age 50 and over in 1996. These subsidies are based on years of service and range between \$40 and \$1,200 per month per person. The other plan provides life insurance coverage to certain retired employees and health insurance for retired directors. None of these plans are pre-funded. The Company utilizes FASB ASC Topic 712 "Compensation – Nonretirement Postemployment Benefits" to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in the funded status in the year in which the changes occur through comprehensive income. The following table sets forth the accumulated postretirement benefit obligation and funded status:

Page 28

|   | At or for the nine months<br>ended September 30, |               |
|---|--|---------------|
|   | 2012   | 2011          |
| Change in benefit obligation            |  |               |
| Benefit obligation at beginning of year | \$1,848,000                                      | \$1,796,000   |
| Service cost                            | 51,000   | 12,000        |
| Interest cost                           | 84,000   | 87,000        |
| Benefits paid                           | (102,000 )                                       | (117,000 )    |
| Benefit obligation at end of period     | 1,881,000  | 1,778,000     |
| Funded status                           |  |               |
| Benefit obligation at end of period     | (1,881,000)                                      | (1,778,000)   |
| Accrued benefit cost at end of period   | \$(1,881,000)                                    | \$(1,778,000) |

The following table sets forth the net periodic pension cost:

|  | For the nine months<br>ended<br>September 30, |           | For the quarters<br>ended<br>September 30, |          |
|--|---|-----------|--|----------|
|  | 2012  | 2011      | 2012                                       | 2011     |
| Components of net periodic benefit cost            |   |           |  |          |
| Service cost                                       | \$51,000                                      | \$12,000  | \$17,000                                   | \$4,000  |
| Interest cost                                      | 84,000  | 87,000    | 28,000                                     | 29,000   |
| Amortization of unrecognized transition obligation | 21,000  | 21,000    | 7,000                                      | 7,000    |
| Amortization of accumulated losses                 | 8,000   | 15,000    | 2,000                                      | 5,000    |
| Net periodic benefit cost                          | \$164,000                                     | \$135,000 | \$54,000                                   | \$45,000 |

Amounts not yet reflected in net periodic benefit cost and included in accumulated other comprehensive income are as follows:

|  | September<br>30,<br>2012 | December<br>31,<br>2011 | September<br>30,<br>2011 |
|--|--------------------------|-------------------------|--------------------------|
| Unamortized net actuarial loss   | \$(100,000)              | \$(100,000)             | \$(49,000 )              |
| Unrecognized transition obligation   | (13,000 )                | (34,000 )               | (42,000 )                |
|  | (113,000)                | (134,000)               | (91,000 )                |
| Deferred tax benefit at 35%  | 41,000                   | 47,000                  | 32,000                   |
| Net unrecognized postretirement benefits included in accumulated other comprehensive income (loss) | \$(72,000 )              | \$(87,000 )             | \$(59,000 )              |

The following table summarizes activity in the unrealized gain or loss on postretirement benefits included in other comprehensive income for the nine months and quarters ended September 30, 2012 and 2011.

|   | For the nine months<br>ended<br>September 30, |            | For the quarters<br>ended<br>September 30, |            |
|---|---|------------|--|------------|
|   | 2012  | 2011       | 2012                                       | 2011       |
| Unrecognized transition obligation at beginning of period | \$(87,000)                                    | \$(73,000) | \$(77,000)                                 | \$(63,000) |
| Amortization of unrecognized transition obligation        | 21,000  | 21,000     | 7,000                                      | 7,000      |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Related deferred taxes                              | (6,000 )   | (7,000 )   | (2,000 )   | (3,000 )   |
| Unrecognized transition obligation at end of period | \$(72,000) | \$(59,000) | \$(72,000) | \$(59,000) |

A weighted average discount rate of 7.0% was used in determining the accumulated benefit obligation and the net periodic benefit cost. The assumed health care cost trend rate is 7.0%. The measurement date for benefit obligations was as of year-end for prior years presented. The expected benefit payments for the fourth quarter of 2012 are \$34,000

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and the expected benefit payments for all of 2012 are \$136,000. Plan expense for 2012 is estimated to be \$190,000. A 1% change in trend assumptions would create an approximate change in the same direction of \$100,000 in the accumulated benefit obligation, \$7,000 in the interest cost and \$1,000 in the service cost.

Note 9 – Goodwill and Other Intangible Assets

As of December 31, 2011, in accordance FASB ASC Topic 350 "Intangibles – Goodwill and Other," the Company completed its annual review of goodwill and determined there has been no impairment.

Note 10 – Mortgage Servicing Rights

FASB ASC Topic 940 "Financial Services – Mortgage Banking," requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. The Company's servicing assets and servicing liabilities are reported using the amortization method and carried at the lower of amortized cost or fair value by strata. In evaluating the carrying values of mortgage servicing rights, the Company obtains third party valuations based on loan level data including note rate, type and term of the underlying loans. The model utilizes several assumptions, the most significant of which is loan prepayments, calculated using a three-month moving average of weekly prepayment data published by the Public Securities Association (PSA) and modeled against the serviced loan portfolio, and the discount rate to discount future cash flows. As of September 30, 2012, the prepayment assumption using the PSA model was 430, which translates into an anticipated prepayment rate of 25.80%. The discount rate is the quarterly average 10 year U.S. Treasury plus 4.89%. Other assumptions include delinquency rates, foreclosure rates, servicing cost inflation, and annual unit loan cost. All assumptions are adjusted periodically to reflect current circumstances. Amortization of mortgage servicing rights, as well as write-offs due to prepayments of the related mortgage loans, are recorded as a charge against mortgage servicing fee income.

For the nine months ended September 30, 2012 and 2011, servicing rights capitalized totaled \$250,000 and \$343,000, respectively. Servicing rights capitalized for the three-month periods ended September 30, 2012 and 2011, were \$169,000 and \$80,000 respectively. Servicing rights amortized for the nine-month periods ended September 30, 2012 and 2011, were \$487,000 and \$399,000, respectively. The fair value of servicing rights was \$1,129,000, \$1,581,000 and \$1,541,000 at September 30, 2012, December 31, 2011 and September 30, 2011, respectively. The Bank serviced loans for others totaling \$215,741,000, \$238,221,000 and \$255,384,000 at September 30, 2012, December 31, 2011, and September 30, 2011, respectively. Mortgage servicing rights are included in other assets and detailed in the following table:

|                           | September<br>30,<br>2012 | December<br>31,<br>2011 | September<br>30,<br>2011 |
|---------------------------|--------------------------|-------------------------|--------------------------|
| Mortgage servicing rights | \$6,346,000              | \$6,099,000             | \$6,067,000              |
| Accumulated amortization  | (5,324,000)              | (4,837,000)             | (4,661,000)              |
| Impairment reserve        | (154,000 )               | (61,000 )               | (211,000 )               |
|                           | \$868,000                | \$1,201,000             | \$1,195,000              |

Note 11 – Income Taxes

FASB ASC Topic 740 "Income Taxes," defines the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. Topic 740 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements. The Company is currently open to audit under the statute of limitations by the IRS for the years ended December 31, 2009 through

2011.

Page 30

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## Note 12- Certificates of Deposit

The following table represents the breakdown of Certificates of Deposit at September 30, 2012 and 2011, and at December 31, 2011:

|                                     | September<br>30, 2012 | December 31,<br>2011 | September<br>30, 2011 |
|-------------------------------------|-----------------------|----------------------|-----------------------|
| Certificates of deposit < \$100,000 | \$210,963,000         | \$216,836,000        | \$231,351,000         |
| Certificates \$100,000 to \$250,000 | 247,095,000           | 309,841,000          | 336,147,000           |
| Certificates \$250,000 and over     | 55,358,000            | 22,499,000           | 26,587,000            |
|                                     | \$513,416,000         | \$549,176,000        | \$594,085,000         |

## Note 13 – Reclassifications

Certain items from the prior year were reclassified in the financial statements to conform with the current year presentation. These do not have a material impact on the balance sheet or statement of income and comprehensive income presentations.

## Note 14 – Fair Value

Certain assets and liabilities are recorded at fair value to provide additional insight into the Company's quality of earnings. Some of these assets and liabilities are measured on a recurring basis while others are measured on a nonrecurring basis, with the determination based upon applicable existing accounting pronouncements. For example, securities available for sale are recorded at fair value on a recurring basis. Other assets, such as, mortgage servicing rights, loans held for sale, and impaired loans, are recorded at fair value on a nonrecurring basis using the lower of cost or market methodology to determine impairment of individual assets. The Company groups assets and liabilities which are recorded at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement (with level 1 considered highest and level 3 considered lowest). A brief description of each level follows.

Level 1 – Valuation is based upon quoted prices for identical instruments in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates that market participants would use in pricing the asset or liability. Valuation includes use of discounted cash flow models and similar techniques.

The most significant instruments that the Company records at fair value include securities which fall into Level 2 in the fair value hierarchy. The securities in the available for sale portfolio are priced by independent providers. In obtaining such valuation information from third parties, the Company has evaluated their valuation methodologies used to develop the fair values in order to determine whether the valuations are representative of an exit price in the Company's principal markets. The Company's principal markets for its securities portfolios are the secondary institutional markets, with an exit price that is predominantly reflective of bid level pricing in those markets.

## Assets and Liabilities Recorded at Fair Value on a Recurring Basis

Securities Available for Sale. Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices for similar assets, if available. If quoted prices are not available, fair values are measured using matrix pricing models, or other model-based valuation techniques requiring observable inputs other than quoted prices such as yield curves, prepayment speeds, and default rates. Recurring Level 1 securities would include U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets. Recurring Level 2 securities include federal agency securities, mortgage-backed securities, collateralized mortgage obligations, municipal bonds and corporate debt securities.

The following table presents the balances of assets and liabilities that were measured at fair value on a recurring basis as of September 30, 2012, December 31, 2011 and September 30, 2011.

|                                  | At September 30, 2012 |                |       |                |
|----------------------------------|-----------------------|----------------|-------|----------------|
|                                  | Level                 |                | Level | Total          |
|                                  | 1                     | Level 2        | 3     |                |
| Securities available for sale    |                       |                |       |                |
| Mortgage-backed securities       | \$-                   | \$ 189,437,000 | \$ -  | \$ 189,437,000 |
| State and political subdivisions | -                     | 108,955,000    | -     | 108,955,000    |
| Corporate securities             | -                     | -              | -     | -              |
| Other equity securities          | -                     | 1,508,000      | -     | 1,508,000      |
| Total assets                     | \$-                   | \$ 299,900,000 | \$ -  | \$ 299,900,000 |

|                                  | At December 31, 2011 |                |       |                |
|----------------------------------|----------------------|----------------|-------|----------------|
|                                  | Level                |                | Level | Total          |
|                                  | 1                    | Level 2        | 3     |                |
| Securities available for sale    |                      |                |       |                |
| Mortgage-backed securities       | \$-                  | \$ 198,232,000 | \$ -  | \$ 198,232,000 |
| State and political subdivisions | -                    | 85,726,000     | -     | 85,726,000     |
| Corporate securities             | -                    | 811,000        | -     | 811,000        |
| Other equity securities          | -                    | 1,433,000      | -     | 1,433,000      |
| Total assets                     | \$-                  | \$ 286,202,000 | \$ -  | \$ 286,202,000 |

|                                  | At September 30, 2011 |                |       |                |
|----------------------------------|-----------------------|----------------|-------|----------------|
|                                  | Level                 |                | Level | Total          |
|                                  | 1                     | Level 2        | 3     |                |
| Securities available for sale    |                       |                |       |                |
| U.S. Treasury and agency         | \$-                   | \$ 16,494,000  | \$ -  | \$ 16,494,000  |
| Mortgage-backed securities       | -                     | 235,038,000    | -     | 235,038,000    |
| State and political subdivisions | -                     | 74,039,000     | -     | 74,039,000     |
| Corporate securities             | -                     | 779,000        | -     | 779,000        |
| Other equity securities          | -                     | 432,000        | -     | 432,000        |
| Total assets                     | \$-                   | \$ 326,782,000 | \$ -  | \$ 326,782,000 |

## Assets and Liabilities Recorded at Fair Value on a Non-Recurring Basis

**Mortgage Servicing Rights.** Mortgage servicing rights represent the value associated with servicing residential mortgage loans. Servicing assets and servicing liabilities are reported using the amortization method. In evaluating the carrying values of mortgage servicing rights, the Company obtains third party valuations based on loan level data including note rate, type and term of the underlying loans and observable inputs for its assumptions. As such, the Company classifies mortgage servicing rights as nonrecurring Level 2.

**Loans Held for Sale.** Mortgage loans held for sale are recorded at the lower of carrying value or fair value. The fair value of mortgage loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies mortgage loans held for sale as nonrecurring Level 2.

**Other Real Estate Owned.** Real estate acquired through foreclosure is initially recorded at fair value. The fair value of other real estate owned is based on property appraisals and an analysis of similar properties currently available. As such, the Company records other real estate owned as nonrecurring Level 2.

**Impaired Loans.** A loan is considered to be impaired when it is probable that all of the principal and interest due under the original underwriting terms of the loan may not be collected. Impairment is measured based on the fair value of the underlying collateral or present value of expected cash flows. As such, the Company records impaired loans as nonrecurring Level 2.

The following tables include assets measured at fair value on a nonrecurring basis that have had a fair value adjustment since their initial recognition. Mortgage servicing rights are presented at fair value. Other real estate owned is presented net of an allowance of \$479,000, \$436,000 and \$602,000 at September 30, 2012, December 31, 2011, and September 30, 2011, respectively. Impaired loans measured at fair value only include impaired loans with a related specific allowance for loan losses and are presented net of specific allowances of \$5,062,000, \$2,058,000 and \$1,627,000 at September 30, 2012, December 31, 2011, and September 30, 2011, respectively.

|                           | At September 30, 2012 |              |       |              |
|---------------------------|-----------------------|--------------|-------|--------------|
|                           | Level                 |              | Level | Total        |
|                           | 1                     | Level 2      | 3     |              |
| Mortgage servicing rights | \$-                   | \$1,129,000  | \$ -  | \$1,129,000  |
| Loans held for sale       | -                     | -            | -     | -            |
| Other real estate owned   | -                     | 5,471,000    | -     | 5,471,000    |
| Impaired loans            | -                     | 16,991,000   | -     | 16,991,000   |
| Total assets              | \$-                   | \$23,591,000 | \$ -  | \$23,591,000 |

|                           | At December 31, 2011 |              |       |              |
|---------------------------|----------------------|--------------|-------|--------------|
|                           | Level                |              | Level | Total        |
|                           | 1                    | Level 2      | 3     |              |
| Mortgage servicing rights | \$-                  | \$1,581,000  | \$ -  | \$1,581,000  |
| Loans held for sale       | -                    | -            | -     | -            |
| Other real estate owned   | -                    | 4,094,000    | -     | 4,094,000    |
| Impaired loans            | -                    | 12,165,000   | -     | 12,165,000   |
| Total assets              | \$-                  | \$17,840,000 | \$ -  | \$17,840,000 |

|                           | At September 30, 2011 |             |       |             |
|---------------------------|-----------------------|-------------|-------|-------------|
|                           | Level                 |             | Level | Total       |
|                           | 1                     | Level 2     | 3     |             |
| Mortgage servicing rights | \$-                   | \$1,541,000 | \$ -  | \$1,541,000 |
| Loans held for sale       | -                     | 230,000     | -     | 230,000     |
| Other real estate owned   | -                     | 6,310,000   | -     | 6,310,000   |

|                |     |              |     |              |
|----------------|-----|--------------|-----|--------------|
| Impaired loans | -   | 8,206,000    | -   | 8,206,000    |
| Total assets   | \$- | \$16,287,000 | \$- | \$16,287,000 |

Fair Value of Financial Instruments

FASB ASC Topic 825 "Financial Instruments", requires disclosures of fair value information about financial instruments, whether or not recognized in the balance sheet, if the fair values can be reasonably determined. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques using observable inputs when available. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Topic 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company. The estimated fair values for financial instruments as of September 30, 2012 were as follows:

|  | Carrying<br>value | Estimated<br>fair value | Level 1       | Level 2       | Level 3     |
|--|-------------------|-------------------------|---------------|---------------|-------------|
| Financial assets                         |                   |                         |               |               |             |
| Cash and cash equivalents                | \$ 14,904,000     | \$ 14,904,000           | \$ 14,904,000 | \$-           | \$-         |
| Interest bearing deposits in other banks | 681,000           | 681,000                 | 681,000       | -             | -           |
| Securities available for sale            | 299,900,000       | 299,900,000             | -             | 299,900,000   | -           |
| Securities to be held to maturity        | 154,256,000       | 162,382,000             | -             | 162,382,000   | -           |
| Restricted equity securities             | 14,448,000        | 14,448,000              | -             | 14,448,000    | -           |
| Loans held for sale                      | -                 | -                       | -             | -             | -           |
| Loans (net of allowance for loan losses) |                   |                         |               |               |             |
| Commercial                               |                   |                         |               |               |             |
| Real estate                              | 250,063,000       | 249,660,000             | -             | 5,000,000     | 244,660,000 |
| Construction                             | 20,702,000        | 20,669,000              | -             | 1,255,000     | 19,414,000  |
| Other                                    | 80,714,000        | 81,077,000              | -             | 1,333,000     | 79,744,000  |
| Municipal                                | 16,428,000        | 18,140,000              | -             | -             | 18,140,000  |
| Residential                              |                   |                         |               |               |             |
| Term                                     | 367,425,000       | 381,809,000             | -             | 9,572,000     | 372,237,000 |
| Construction                             | 6,512,000         | 6,496,000               | -             | -             | 6,496,000   |
| Home equity line of credit               | 99,202,000        | 99,938,000              | -             | 273,000       | 99,665,000  |
| Consumer                                 | 14,086,000        | 14,511,000              | -             | -             | 14,511,000  |
| Total loans                              | 855,132,000       | 872,300,000             | -             | 17,433,000    | 854,867,000 |
| Mortgage servicing rights                | 868,000           | 1,129,000               | -             | 1,129,000     | -           |
| Accrued interest receivable              | 5,425,000         | 5,425,000               | -             | 5,425,000     | -           |
| Financial liabilities                    |                   |                         |               |               |             |
| Demand deposits                          | \$ 89,500,000     | \$ 91,729,000           | \$-           | \$ 91,729,000 | \$-         |
| NOW deposits                             | 136,472,000       | 132,566,000             | -             | 132,566,000   | -           |
| Money market deposits                    | 74,805,000        | 67,105,000              | -             | 67,105,000    | -           |
| Savings deposits                         | 130,354,000       | 122,897,000             | -             | 122,897,000   | -           |
| Local certificates of deposit            | 211,578,000       | 217,180,000             | -             | 217,180,000   | -           |
| National certificates of deposit         | 301,838,000       | 306,061,000             | -             | 306,061,000   | -           |
| Total deposits                           | 944,547,000       | 937,538,000             | -             | 937,538,000   | -           |
| Repurchase agreements                    | 114,817,000       | 114,817,000             | -             | 114,817,000   | -           |
| Federal Home Loan Bank advances          | 189,932,000       | 198,704,000             | -             | 198,704,000   | -           |
| Total borrowed funds                     | 304,749,000       | 313,521,000             | -             | 313,521,000   | -           |
| Accrued interest payable                 | 618,000           | 618,000                 | -             | 618,000       | -           |



The estimated fair values for financial instruments as of December 31, 2011 and September 30, 2011 were as follows:

|  | December 31, 2011 |                      | September 30, 2011 |                      |
|--|-------------------|----------------------|--------------------|----------------------|
|  | Carrying amount   | Estimated fair value | Carrying amount    | Estimated fair value |
| <b>Financial assets</b>                  |                   |                      |                    |                      |
| Cash and cash equivalents                | \$ 14,115,000     | \$ 14,115,000        | \$ 16,563,000      | \$ 16,563,000        |
| Interest-bearing deposits in other banks | -                 | -                    | 100,000            | 100,000              |
| Securities available for sale            | 286,202,000       | 286,202,000          | 326,782,000        | 326,782,000          |
| Securities to be held to maturity        | 122,661,000       | 130,677,000          | 129,699,000        | 137,227,000          |
| Restricted equity securities             | 15,443,000        | 15,443,000           | 15,443,000         | 15,443,000           |
| Loans held for sale                      | -                 | -                    | 230,000            | 230,000              |
| Loans (net of allowance for loan losses) | 851,988,000       | 866,442,000          | 853,254,000        | 869,209,000          |
| Mortgage servicing rights                | 1,201,000         | 1,581,000            | 1,195,000          | 1,541,000            |
| Accrued interest receivable              | 4,835,000         | 4,835,000            | 5,018,000          | 5,018,000            |
| <b>Financial liabilities</b>             |                   |                      |                    |                      |
| Deposits                                 | \$ 941,333,000    | \$ 921,388,000       | \$ 1,004,894,000   | \$ 981,577,000       |
| Borrowed funds                           | 265,663,000       | 273,568,000          | 255,616,000        | 265,118,000          |
| Accrued interest payable                 | 734,000           | 734,000              | 702,000            | 702,000              |

The fair value estimates, methods, and assumptions for the Company's financial instruments are set forth below.

#### Cash and Cash Equivalents and Due from Banks

The carrying values of cash and cash equivalents and due from banks approximate their relative fair values. As such, the Company classifies cash and cash equivalents as Level 1.

#### Investment Securities

The fair values of investment securities are estimated by independent providers. In obtaining such valuation information from third parties, the Company has evaluated their valuation methodologies used to develop the fair values in order to determine whether the valuations are representative of an exit price in the Company's principal markets. The Company's principal markets for its securities portfolios are the secondary institutional markets, with an exit price that is predominantly reflective of bid level pricing in those markets. Fair values are calculated based on the value of one unit without regard to any premium or discount that may result from concentrations of ownership of a financial instrument, possible tax ramifications, or estimated transaction costs. If these considerations had been incorporated into the fair value estimates, the aggregate fair value could have been changed. The carrying values of restricted equity securities approximate fair values. As such, the Company classifies investment securities as Level 2.

#### Loans Held for Sale.

Loans held for sale are recorded at the lower of carrying value or market value. The fair value of mortgage loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies mortgage loans held for sale as nonrecurring Level 2.

#### Loans

Fair values are estimated for portfolios of loans with similar financial characteristics. The fair values of performing loans are calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest risk inherent in the loan. The estimates of maturity are based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions, and the effects of estimated prepayments. Assumptions

regarding credit risk, cash flows, and discount rates are judgmentally determined using available market information and specific borrower information. Management has made estimates of fair value using discount rates that it believes to be reasonable. However, because there are significant Management assumptions and there is no active market for many of these financial instruments, Management has no basis to determine whether the fair value presented above would be indicative of the value negotiated in an actual sale. As such, the Company classifies loans as Level 3. Fair

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Page 35



values for impaired loans are based on estimated cash flows, discounted using a rate commensurate with the risk associated with the estimated cash flows, or, if collateral dependent, discounted to the appraised value of the collateral, less cost to sell. As such, the Company classifies impaired loans as Level 2.

#### Mortgage Servicing Rights.

Mortgage servicing rights represent the value associated with servicing residential mortgage loans. Servicing assets and servicing liabilities are reported using the amortization method. In evaluating the carrying values of mortgage servicing rights, the Company obtains third party valuations based on loan level data including note rate, type and term of the underlying loans and observable inputs for its assumptions. As such, the Company classifies mortgage servicing rights as nonrecurring Level 2.

#### Accrued Interest Receivable

The fair value estimate of this financial instrument approximates the carrying value as this financial instrument has a short maturity. It is the Company's policy to stop accruing interest on loans for which it is probable that the interest is not collectible. Therefore, this financial instrument has been adjusted for estimated credit loss. As such, the Company classifies accrued interest receivable as Level 2.

#### Deposits

The fair value of deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposits compared to the cost of borrowing funds in the market. If that value were considered, the fair value of the Company's net assets could increase. As such, the Company classifies deposits as Level 2.

#### Borrowed Funds

The fair value of borrowed funds is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently available for borrowings of similar remaining maturities. As such, the Company classifies borrowed funds as Level 2.

#### Accrued Interest Payable

The fair value estimate approximates the carrying amount as this financial instrument has a short maturity. As such, the Company classifies accrued interest payable as Level 2.

#### Off-Balance-Sheet Instruments

Off-balance-sheet instruments include loan commitments. Fair values for loan commitments have not been presented as the future revenue derived from such financial instruments is not significant.

#### Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These values do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on Management's judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on- and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial instruments include the deferred

tax asset, premises and equipment, and other real estate owned. In addition, tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

Note 15 – Subsequent Event

On October 26, 2012, the Bank completed the purchase of a branch at 63 Union Street in Rockland, Maine, from Camden National Bank (Camden National). The branch represents one of 15 Maine branches Camden National acquired from Bank of America and divested by Camden National to resolve competitive concerns in that market raised by the U.S. Department of Justice's Antitrust Division. As part of the transaction, the Bank acquired approximately \$32.3 million in deposits as well as a small volume of loans.

On the same date, the Bank completed the purchase a full-service bank building at 145 Exchange Street in Bangor, Maine, also from Camden National, and expects to open a full-service branch in this building in the first quarter of 2013. This Bangor location offers an excellent opportunity to enter the expanding Northern Maine market.

The total value of the transaction is estimated to be \$6.7 million, which includes the premises and equipment for the two locations plus the premium paid for the Rockland deposits.

Note 16 – Impact of Recently Issued Accounting Standards

In May 2011, the FASB issued Accounting Standards Update ("ASU") No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. This ASU clarifies how to measure fair value, but does not require additional fair value measurement and is not intended to affect current valuation practices outside of financial reporting. However, additional information and disclosure will be required for transfers between Level 1 and Level 2, the sensitivity of a fair value measurement categorized as Level 3, and the categorization of items that are not measured at fair value by level of the fair value hierarchy. The guidance is effective during interim and annual reporting periods beginning after December 15, 2011. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements. In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. This ASU requires that all nonowner changes in shareholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Other than the manner of presentation, the adoption of this new guidance did not have a material effect on the Company's consolidated financial statements.

In August 2011, the FASB issued ASU No. 2011-08, Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment. This ASU permits 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 described in Topic 350. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. The guidance is effective for fiscal years ending after December 15, 2011, with early adoption permitted. The Company believes the adoption of this new guidance will not have a material effect on the Company's consolidated financial statements.

Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

The First Bancorp, Inc. and Subsidiary

Forward-Looking Statements

This report contains statements that are "forward-looking statements." We may also make written or oral forward-looking statements in other documents we file with the Securities and Exchange Commission ("SEC"), in our annual reports to shareholders, in press releases and other written materials, and in oral statements made by our officers, directors or employees. You can identify forward-looking statements by the use of the words "believe," "expect," "anticipate," "intend," "estimate," "assume," "outlook," "will," "should," and other expressions that predict or indicate future events and trends and which do not relate to historical matters. You should not rely on forward-looking statements, because they involve known and unknown risks, uncertainties and other factors, some of which are beyond the control of the Company. These risks, uncertainties and other factors may cause the actual results, performance or achievements of the Company to be materially different from the anticipated future results, performance or achievements expressed or implied by the forward-looking statements.

Some of the factors that might cause these differences include the following: changes in general national, regional or international economic conditions or conditions affecting the banking or financial services industries or financial capital markets, volatility and disruption in national and international financial markets, government intervention in the U.S. financial system, reductions in net interest income resulting from interest rate volatility as well as changes in the balance and mix of loans and deposits, reductions in the market value of wealth management assets under administration, changes in the value of securities and other assets, reductions in loan demand, changes in loan collectability, default and charge-off rates, changes in the size and nature of the Company's competition, changes in legislation or regulation and accounting principles, policies and guidelines, and changes in the assumptions used in making such forward-looking statements. In addition, the factors described under "Risk Factors" in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, as filed with the SEC, may result in these differences. You should carefully review all of these factors, and you should be aware that there may be other factors that could cause these differences. These forward-looking statements were based on information, plans and estimates at the date of this quarterly report, and we assume no obligation to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.

Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from the results discussed in these forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Readers are also urged to carefully review and consider the various disclosures made by the Company, which attempt to advise interested parties of the facts that affect the Company's business.

Critical Accounting Policies

Management's discussion and analysis of the Company's financial condition is based on the consolidated financial statements which are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of such financial statements requires Management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an ongoing basis, Management evaluates its estimates, including those related to the allowance for loan losses, goodwill, the valuation of mortgage servicing rights, and other-than-temporary impairment on securities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis in making judgments about the carrying values

of assets that are not readily apparent from other sources. Actual results could differ from the amount derived from Management's estimates and assumptions under different assumptions or conditions.

Allowance for Loan Losses. Management believes the allowance for loan losses requires the most significant estimates and assumptions used in the preparation of the consolidated financial statements. The allowance for loan losses is based on Management's evaluation of the level of the allowance required in relation to the estimated loss exposure in the loan portfolio. Management believes the allowance for loan losses is a significant estimate and

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Page 38

therefore regularly evaluates it to determine the appropriate level by taking into consideration factors such as prior loan loss experience, the character and size of the loan portfolio, business and economic conditions and Management's estimation of potential losses. The use of different estimates or assumptions could produce different provisions for loan losses.

**Goodwill.** Management utilizes numerous techniques to estimate the value of various assets held by the Company, including methods to determine the appropriate carrying value of goodwill as required under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 350 "Intangibles – Goodwill and Other." In addition, goodwill from a purchase acquisition is subject to ongoing periodic impairment tests, which include an evaluation of the ongoing assets, liabilities and revenues from the acquisition and an estimation of the impact of business conditions.

**Mortgage Servicing Rights.** The valuation of mortgage servicing rights is a critical accounting policy which requires significant estimates and assumptions. The Bank often sells mortgage loans it originates and retains the ongoing servicing of such loans, receiving a fee for these services, generally 0.25% of the outstanding balance of the loan per annum. Mortgage servicing rights are recognized at fair value when they are acquired through the sale of loans, and are reported in other assets. They are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. The rights are subsequently carried at the lower of amortized cost or fair value. Management uses an independent firm which specializes in the valuation of mortgage servicing rights to determine the fair value which is recorded on the balance sheet. The most important assumption is the anticipated loan prepayment rate, and increases in prepayment speed results in lower valuations of mortgage servicing rights. The valuation also includes an evaluation for impairment based upon the fair value of the rights, which can vary depending upon current interest rates and prepayment expectations, as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. The use of different assumptions could produce a different valuation. All of the assumptions are based on standards the Company believes would be utilized by market participants in valuing mortgage servicing rights and are consistently derived and/or benchmarked against independent public sources.

**Other-Than-Temporary Impairment on Securities.** One of the significant estimates related to investment securities is the evaluation of other-than-temporary impairments. The evaluation of securities for other-than-temporary impairments is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of investments should be recognized in current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition and/or future prospects, the effects of changes in interest rates or credit spreads and the expected recovery period of unrealized losses. Securities that are in an unrealized loss position are reviewed at least quarterly to determine if other-than-temporary impairment is present based on certain quantitative and qualitative factors and measures. The primary factors considered in evaluating whether a decline in value of securities is other-than-temporary include: (a) the length of time and extent to which the fair value has been less than cost or amortized cost and the expected recovery period of the security, (b) the financial condition, credit rating and future prospects of the issuer, (c) whether the debtor is current on contractually obligated interest and principal payments, (d) the volatility of the securities' market price, (e) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for recovery, which may be at maturity and (f) any other information and observable data considered relevant in determining whether other-than-temporary impairment has occurred, including the expectation of receipt of all principal and interest when due.

#### Use of Non-GAAP Financial Measures

Certain information in Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Report contains financial information determined by methods other than in accordance with accounting principles generally accepted in the United States of America ("GAAP"). Management uses these "non-GAAP" measures in its analysis of the Company's performance and believes that these non-GAAP financial

measures provide a greater understanding of ongoing operations and enhance comparability of results with prior periods as well as demonstrating the effects of significant gains and charges in the current period. The Company believes that a meaningful analysis of its financial performance requires an understanding of the factors underlying that performance. Management believes that investors may use these non-GAAP financial measures to analyze financial performance without the impact of unusual items that may obscure trends in the Company's underlying performance. These disclosures should not be viewed as a substitute for operating results determined in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

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In several places net interest income is presented on a fully taxable- equivalent basis. Specifically included in interest income was tax-exempt interest income from certain investment securities and loans. An amount equal to the tax benefit derived from this tax exempt income has been added back to the interest income total, which adjustments increased net interest income accordingly. Management believes the disclosure of tax-equivalent net interest income information improves the clarity of financial analysis, and is particularly useful to investors in understanding and evaluating the changes and trends in the Company's results of operations. Other financial institutions commonly present net interest income on a tax-equivalent basis. This adjustment is considered helpful in the comparison of one financial institution's net interest income to that of another, as each will have a different proportion of tax-exempt interest from its earning assets. Moreover, net interest income is a component of a second financial measure commonly used by financial institutions, net interest margin, which is the ratio of net interest income to average earning assets. For purposes of this measure as well, other financial institutions generally use tax-equivalent net interest income to provide a better basis of comparison from institution to institution. The Company follows these practices. The following table provides a reconciliation of tax-equivalent financial information to the Company's consolidated financial statements prepared in accordance with GAAP. A 35.0% tax rate was used in both 2012 and 2011.

| Dollars in thousands                | For the nine<br>months ended<br>September 30, |          | For the quarters<br>ended<br>September 30, |          |
|-------------------------------------|---|----------|--|----------|
|                                     | 2012  | 2011     | 2012                                       | 2011     |
| Net interest income as presented    | \$29,394                                      | \$30,953 | \$9,670                                    | \$10,228 |
| Effect of tax-exempt income         | 2,318   | 1,978    | 792  | 700      |
| Net interest income, tax equivalent | \$31,712                                      | \$32,931 | \$10,462                                   | \$10,928 |

The Company presents its efficiency ratio using non-GAAP information. The GAAP-based efficiency ratio is noninterest expenses divided by net interest income plus noninterest income from the Consolidated Statements of Income and Comprehensive Income. The non-GAAP efficiency ratio excludes securities losses and other-than-temporary impairment charges from noninterest expenses, excludes securities gains from noninterest income, and adds the tax-equivalent adjustment to net interest income. The following table provides a reconciliation between the GAAP and non-GAAP efficiency ratio:

| Dollars in thousands                                  | For the nine months<br>ended<br>September 30, |          | For the quarters<br>ended<br>September 30, |          |
|---|---|----------|--|----------|
|   | 2012  | 2011     | 2012                                       | 2011     |
| Non-interest expense, as presented                    | \$19,503                                      | \$19,669 | \$6,595                                    | \$6,934  |
| Net interest income, as presented                     | 29,394  | 30,953   | 9,670                                      | 10,228   |
| Effect of tax-exempt income                           | 2,318   | 1,978    | 792  | 700      |
| Non-interest income, as presented                     | 8,556   | 6,591    | 2,492                                      | 2,080    |
| Effect of non-interest tax-exempt income              | 137   | 140      | 46   | 47       |
| Net securities gains                                  | (1,967 )                                      | (237 )   | -  | (8 )     |
| Adjusted net interest income plus non-interest income | \$38,438                                      | \$39,425 | \$13,000                                   | \$13,047 |
| Non-GAAP efficiency ratio                             | 50.74 %                                       | 49.89 %  | 50.73 %                                    | 53.15 %  |
| GAAP efficiency ratio                                 | 51.39 %                                       | 52.39 %  | 54.23 %                                    | 56.35 %  |

The Company presents certain information based upon tangible average shareholders' equity instead of total average shareholders' equity. The difference between these measures is the Company's intangible assets, specifically goodwill from prior acquisitions. Management, banking regulators and many stock analysts use the tangible common equity



ratio and the tangible book value per common share in conjunction with more traditional bank capital ratios to compare the capital adequacy of banking organizations with significant amounts of goodwill or other intangible assets, typically stemming from the use of the purchase accounting method in accounting for mergers and acquisitions. The

Page 40

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following table provides a reconciliation of tangible average shareholders' equity to the Company's consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles:

|   | For the nine months ended |            | For the quarters ended |            |
|---|---------------------------|------------|------------------------|------------|
|   | September 30,             |            | September 30,          |            |
| Dollars in thousands                      | 2012                      | 2011       | 2012                   | 2011       |
| Average shareholders' equity as presented | \$ 154,955                | \$ 152,513 | \$ 156,475             | \$ 149,916 |
| Less preferred stock                      | (12,329 )                 | (22,990 )  | (12,353 )              | (19,591 )  |
| Less intangible assets                    | (27,684 )                 | (27,684 )  | (27,684 )              | (27,684 )  |
| Tangible average shareholders' equity     | \$ 114,942                | \$ 101,839 | \$ 116,438             | \$ 102,641 |

### Executive Summary

Net income for the first nine months of 2012 was \$9.5 million, up \$118,000 or 1.3% from the same period in 2011. Earnings per common share on a fully diluted basis were \$0.91 for the nine months ended September 30, 2012, up \$0.06 or 7.1% from the \$0.85 posted for the same period in 2011. For the quarter ended September 30, 2012, net income was \$3.2 million, up \$217,000 or 7.2% from the same period in 2011. Earnings per common share on a fully diluted basis were \$0.31 for the quarter ended September 30, 2012, up \$0.04 or 14.8% from the \$0.27 posted in 2011. Compared to the previous quarter, net income was down \$100,000 or 3.0% and earnings per common share on a fully diluted basis were down \$0.01 or 3.1%.

These are the second-best quarterly earnings the Company has posted in the past three years. Net income in the third quarter is at the upper end of the \$2.9 million to \$3.3 million range that we have seen over the past ten quarters. Similar results can be seen in asset quality, such as the level of non-performing assets, which have ranged from a low of 1.87% to a high of 2.32% over the past ten quarters and ended the third quarter at 2.04% of total assets. We still see weaknesses in the economy, however, with continued low interest rates and lower net interest income. Economic weakness has resulted in higher credit losses while low interest rates have created margin compression and lower net interest income.

Net interest income on a tax-equivalent basis was down \$1,219,000 or 3.7% in the first nine months of 2012 compared to the same period in 2011. Compression can be seen in our net interest margin, which dropped from 3.29% for the first nine months of 2011 to 3.16% for same period in 2012. This is the result of the low interest rate environment, with a higher volume of assets continuing to reprice downward without the opportunity to reprice a comparable volume of liabilities. For the quarter ended September 30, 2012, net interest income on a tax-equivalent basis declined \$466,000 or 4.3% compared to the same period in 2011. Compared to the previous quarter, net interest income on a tax-equivalent basis was down \$219,000 or 2.1%. The decline in net interest income was offset by increased non-interest income.

Non-interest income in the first nine months of 2012 was \$2.0 million or 29.8% higher than in the first nine months of 2011. This was attributable to an increase in net securities gain. Non-interest expense was \$166,000 or 0.8% lower than in the same period in 2011, with lower costs for collections and other real estate owned. For the quarter ended September 30, 2012, non-interest income increased \$412,000 or 19.8% compared to the same period in 2011. This was attributable to strong mortgage origination income as well as an increase in investment management and fiduciary income. Non-interest expense was \$339,000 or 4.9% lower than in the same period in 2011, with stable employee costs and lower cost for other real estate owned.

While unemployment and housing prices may be showing slight improvement, our economy is still sluggish and these two factors have the greatest impact on credit quality. Net loan chargeoffs for the nine months ended September 30, 2012, were \$4.6 million or 0.70% of average loans on an annualized basis. This was up \$1.0 million from net chargeoffs of \$3.6 million or 0.54% of average loans on an annualized basis for the first nine months of 2011. We

provisioned \$6.3 million for loan losses in the first nine months of 2012, up \$700,000 from the amount provisioned in the first nine months of 2011. The allowance for loan losses increased \$1.7 million between December 31, 2011 and September 30, 2012, and is 1.69% of loans outstanding compared to 1.50% at year end and 1.76% a year ago. Total past-due loans were 2.27% of total loans as of September 30, 2012, well below 3.07% of total loans as of December 31, 2011, and slightly above 2.21% of total loans as of September 30, 2011.

Total assets have increased \$50.4 million or 3.7% year-to-date. The loan portfolio increased \$4.9 million in the first nine months of 2012 and \$1.3 million from a year ago. The investment portfolio has increased \$44.3 million or 10.4% year-to-date and decreased \$3.3 million or 0.7% from a year ago. On the liability side of the balance sheet,

Page 41

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low-cost deposits have increased \$43.2 million or 13.8% year-to-date, and \$23.3 or 7.0% over the past year, which is well above our normal seasonal pattern. Local certificates of deposit decreased \$8.4 million and wholesale CDs decreased \$26.4 million year-to-date.

Remaining well capitalized remains a top priority for The First Bancorp. Since December 31, 2008, the Company's total risk-based capital ratio has increased from 11.13% to 16.25%, well above the well-capitalized threshold of 10.0% set by the FDIC. In Management's view, participating in the U.S. Treasury Capital Purchase Program (the "CPP") was the right decision for The First Bancorp. The Company obtained additional capital at a relatively low cost and it provides us with greater ability to ride out the current economic storm and allows us more flexibility to work with individuals and businesses as they too struggle through these adverse economic conditions. During the quarter ended September 30, 2011, the Company repaid \$12.5 million preferred stock issued by the U.S. Treasury under the CPP. After the repurchase, \$12.5 million of CPP preferred stock remains outstanding.

The Company's operating ratios remain good, with a return on average tangible common equity of 10.36% for the nine months ended September 30, 2012 compared to 10.92% for the same period in 2011. Based upon June 30, 2012 data, our return on average tangible equity was in the top 58% of all banks in the UBPR peer group, which had an average return on equity of 9.08%. Our efficiency ratio continues to be an important component in our overall performance; and, was up slightly to 50.74% for the first nine months of 2012 compared to 49.89% for the same period in 2011. As of June 30, 2012, the average efficiency ratio for our UBPR peer group was 65.79%, which put us in the top 11% of all banks in the UBPR peer group.

On October 26, 2012, the Bank completed the purchase of a branch at 63 Union Street in Rockland, Maine, from Camden National Bank (Camden National). The branch represents one of 15 Maine branches Camden National acquired from Bank of America and divested by Camden National to resolve competitive concerns in that market raised by the U.S. Department of Justice's Antitrust Division. As part of the transaction, the Bank acquired approximately \$32.3 million in deposits as well as a small volume of loans.

On the same date, the Bank completed the purchase a full-service bank building at 145 Exchange Street in Bangor, Maine, also from Camden National, and expects to open a full-service branch in this building in the first quarter of 2013. This Bangor location offers an excellent opportunity to enter the expanding Northern Maine market.

The total value of the transaction is estimated to be \$6.7 million, which includes the premises and equipment for the two locations plus the premium paid for the Rockland deposits.

#### Net Interest Income

Total interest income of \$39.1 million for the nine months ended September 30, 2012, was a decrease of \$3.0 million or 7.2% compared to total interest income of \$42.1 for the same period of 2011. Total interest expense of \$9.7 million for the first nine months of 2012 is a \$1.5 million or 13.0% decrease from total interest expense of \$11.2 million for the first nine months of 2011. As a result, net interest income decreased 5.0% or \$1.5 million to \$29.4 million for the nine months ended September 30, 2012, from the \$31.0 million reported for the same period in 2011. The Company's net interest margin on a tax-equivalent basis decreased from 3.29% in the first nine months of 2011 to 3.16% for the nine months ended September 30, 2012. This is the result of the low interest rate environment with a higher volume of assets continuing to reprice downward without the opportunity to reprice a comparable volume of liabilities.

Tax-exempt interest income amounted to \$4.3 million and \$3.7 million for the nine months ended September 30, 2012 and 2011, respectively.

Total interest income of \$12.9 million for the quarter ended September 30, 2012 is a 7.2% decrease from total interest income of \$13.9 million in the comparable period of 2011. Total interest expense of \$3.2 million for the quarter ended September 30, 2012 is a 12.2% decrease from total interest expense of \$3.7 million for the comparable period of 2011. As a result, net interest income decreased 5.5% or \$558,000 to \$9.7 million for the quarter ended September 30, 2012, from the \$10.2 million reported for the same period in 2011. The Company's net interest margin on a tax-equivalent basis decreased from 3.24% for the quarter ended September 30, 2011 to 3.12% for the quarter ended September 30, 2012. Tax-exempt interest income amounted to \$1.5 million and \$1.3 million for the quarters ended September 30,

2012 and 2011, respectively.

Page 42

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The following tables present the amount of interest earned or paid, as well as the average yield or rate on an annualized basis, for each major category of assets or liabilities for the nine months and quarters ended September 30, 2012 and 2011. Tax-exempt income is calculated on a tax-equivalent basis, using a 35.0% tax rate in 2012 and 2011.

| Dollars in thousands               | For the nine months ended |                       |   |                          |                       |   |
|------------------------------------|---------------------------|-----------------------|---|--------------------------|-----------------------|---|
|                                    | September 30, 2012        |                       |   | September 30, 2011       |                       |   |
|                                    | Amount<br>of<br>interest  | Average<br>Yield/Rate |   | Amount<br>of<br>interest | Average<br>Yield/Rate |   |
| Interest on earning assets         |                           |                       |   |                          |                       |   |
| Interest-bearing deposits          | \$3                       | 0.23                  | % | \$-                      | 0.40                  | % |
| Investments                        | 13,180                    | 3.82                  | % | 13,749                   | 4.09                  | % |
| Loans held for sale                | 8                         | 3.46                  | % | 25                       | 3.99                  | % |
| Loans                              | 28,258                    | 4.31                  | % | 30,350                   | 4.56                  | % |
| Total interest-earning assets      | 41,449                    | 4.14                  | % | 44,124                   | 4.41                  | % |
| Interest-bearing liabilities       |                           |                       |   |                          |                       |   |
| Deposits                           | 6,370                     | 0.93                  | % | 7,478                    | 1.05                  | % |
| Other borrowings                   | 3,367                     | 1.76                  | % | 3,715                    | 2.09                  | % |
| Total interest-bearing liabilities | 9,737                     | 1.11                  | % | 11,193                   | 1.26                  | % |
| Net interest income                | \$31,712                  |                       |   | \$32,931                 |                       |   |
| Interest rate spread               |                           | 3.03                  | % |                          | 3.15                  | % |
| Net interest margin                |                           | 3.16                  | % |                          | 3.29                  | % |

| Dollars in thousands               | For the quarters ended   |                       |   |                          |                       |   |
|------------------------------------|--------------------------|-----------------------|---|--------------------------|-----------------------|---|
|                                    | September 30, 2012       |                       |   | September 30, 2011       |                       |   |
|                                    | Amount<br>of<br>interest | Average<br>Yield/Rate |   | Amount<br>of<br>interest | Average<br>Yield/Rate |   |
| Interest on earning assets         |                          |                       |   |                          |                       |   |
| Interest-bearing deposits          | \$2                      | 0.29                  | % | \$-                      | 0.40                  | % |
| Investments                        | 4,351                    | 3.78                  | % | 4,539                    | 3.94                  | % |
| Loans held for sale                | 4                        | 3.51                  | % | 5                        | 4.79                  | % |
| Loans                              | 9,327                    | 4.24                  | % | 10,054                   | 4.54                  | % |
| Total interest-earning assets      | 13,684                   | 4.08                  | % | 14,598                   | 4.33                  | % |
| Interest-bearing liabilities       |                          |                       |   |                          |                       |   |
| Deposits                           | 2,073                    | 0.92                  | % | 2,397                    | 1.02                  | % |
| Other borrowings                   | 1,149                    | 1.74                  | % | 1,273                    | 2.04                  | % |
| Total interest-bearing liabilities | 3,222                    | 1.11                  | % | 3,670                    | 1.23                  | % |
| Net interest income                | \$10,462                 |                       |   | \$10,928                 |                       |   |
| Interest rate spread               |                          | 2.97                  | % |                          | 3.10                  | % |
| Net interest margin                |                          | 3.12                  | % |                          | 3.24                  | % |

The following tables present changes in interest income and expense attributable to changes in interest rates and volume for interest-earning assets and liabilities for the nine months and quarters ended September 30, 2012 compared to 2011. Tax-exempt income is calculated on a tax-equivalent basis, using a 35.0% tax rate in 2012 and 2011.

For the nine months ended September 30, 2012  
compared to 2011

| Dollars in thousands          | Volume    | Rate      | Rate/Volume <sup>1</sup> | Total     |
|-------------------------------|-----------|-----------|--------------------------|-----------|
| Interest on earning assets    |           |           |                          |           |
| Interest-bearing deposits     | \$ 5      | \$-       | \$ (2 )                  | ) \$3     |
| Investment securities         | 370       | (914 )    | (25 )                    | ) (569 )  |
| Loans held for sale           | (16 )     | (3 )      | 2                        | (17 )     |
| Loans                         | (470 )    | (1,648)   | 26                       | (2,092)   |
| Total interest income         | (111 )    | (2,565)   | 1                        | (2,675)   |
| Interest expense              |           |           |                          |           |
| Deposits                      | (270 )    | (870 )    | 32                       | (1,108)   |
| Other borrowings              | 283       | (587 )    | (44 )                    | ) (348 )  |
| Total interest expense        | 13        | (1,457)   | (12 )                    | ) (1,456) |
| Change in net interest income | \$ (124 ) | \$(1,108) | \$ 13                    | \$(1,219) |

<sup>1</sup> Represents the change attributable to a combination of change in rate and change in volume.

For the quarters ended September 30, 2012  
compared to 2011

| Dollars in thousands          | Volume   | Rate    | Rate/Volume <sup>1</sup> | Total   |
|-------------------------------|----------|---------|--------------------------|---------|
| Interest on earning assets    |          |         |                          |         |
| Interest-bearing deposits     | \$ 4     | \$-     | \$ (2 )                  | ) \$2   |
| Investment securities         | 1        | (189)   | -                        | (188)   |
| Loans held for sale           | 1        | (1 )    | (1 )                     | ) (1 )  |
| Loans                         | (57 )    | (675)   | 5                        | (727)   |
| Total interest income         | (51 )    | (865)   | 2                        | (914)   |
| Interest expense              |          |         |                          |         |
| Deposits                      | (103 )   | (231)   | 10                       | (324)   |
| Other borrowings              | 81       | (192)   | (13 )                    | ) (124) |
| Total interest expense        | (22 )    | (423)   | (3 )                     | ) (448) |
| Change in net interest income | \$ (29 ) | \$(442) | \$ 5                     | \$(466) |

Page 44

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## Average Daily Balance Sheets

The following table shows the Company's average daily balance sheets for the nine-month periods and quarters ended September 30, 2012 and 2011.

| Dollars in thousands                                 | For the nine months ended |                    | For the quarters ended |                    |
|--|---------------------------|--------------------|------------------------|--------------------|
|  | September 30, 2012        | September 30, 2011 | September 30, 2012     | September 30, 2011 |
| <b>Assets</b>  |                           |                    |                        |                    |
| Cash and cash equivalents                            | \$13,748                  | \$18,815           | \$15,797               | \$25,656           |
| Time deposits in other banks                         | 1,727                     | 100                | 2,707                  | 100                |
| Securities available for sale                        | 310,137                   | 320,630            | 306,229                | 319,397            |
| Securities to be held to maturity                    | 136,364                   | 113,218            | 136,751                | 122,449            |
| Restricted equity securities, at cost                | 14,780                    | 15,443             | 14,448                 | 15,443             |
| Loans held for sale (fair value approximates cost)   | 309                       | 838                | 454                    | 414                |
| Loans  | 875,208                   | 888,971            | 874,639                | 879,496            |
| Allowance for loan losses                            | (13,635 )                 | (14,504 )          | (14,588 )              | (15,142 )          |
| Net loans  | 861,573                   | 874,467            | 860,051                | 864,354            |
| Accrued interest receivable                          | 5,174                     | 5,406              | 5,084                  | 5,239              |
| Premises and equipment                               | 18,656                    | 18,584             | 18,451                 | 18,306             |
| Other real estate owned                              | 4,605                     | 5,768              | 4,954                  | 6,491              |
| Goodwill   | 27,684                    | 27,684             | 27,684                 | 27,684             |
| Other assets   | 26,630                    | 28,103             | 26,893                 | 27,810             |
| <b>Total Assets</b>                                  | <b>\$1,421,387</b>        | <b>\$1,429,056</b> | <b>\$1,419,503</b>     | <b>\$1,433,343</b> |
| <b>Liabilities &amp; Shareholders' Equity</b>        |                           |                    |                        |                    |
| Demand deposits                                      | \$76,953                  | \$74,814           | \$87,001               | \$86,323           |
| NOW deposits   | 124,570                   | 122,132            | 130,926                | 124,496            |
| Money market deposits                                | 75,156                    | 73,001             | 73,134                 | 74,113             |
| Savings deposits                                     | 120,508                   | 107,885            | 126,031                | 112,632            |
| Certificates of deposit                              | 597,767                   | 649,312            | 566,039                | 625,194            |
| <b>Total deposits</b>                                | <b>994,954</b>            | <b>1,027,144</b>   | <b>983,131</b>         | <b>1,022,758</b>   |
| Borrowed funds – short term                          | 115,811                   | 135,451            | 123,021                | 127,348            |
| Borrowed funds – long term                           | 140,157                   | 102,376            | 140,157                | 120,164            |
| Dividends payable                                    | 933                       | 987                | 905                    | 1,000              |
| Other liabilities                                    | 14,577                    | 10,585             | 15,814                 | 12,157             |
| <b>Total Liabilities</b>                             | <b>1,266,432</b>          | <b>1,276,543</b>   | <b>1,263,028</b>       | <b>1,283,427</b>   |
| <b>Shareholders' Equity:</b>                         |                           |                    |                        |                    |
| Preferred stock                                      | 12,329                    | 22,990             | 12,353                 | 19,591             |
| Common stock   | 98                        | 98                 | 98                     | 98                 |
| Additional paid-in capital                           | 46,073                    | 45,611             | 46,173                 | 45,687             |
| Retained earnings                                    | 87,982                    | 82,553             | 89,128                 | 80,113             |
| Net unrealized gain on securities available-for-sale | 8,552                     | 1,326              | 8,797                  | 4,487              |
| Net unrealized loss on postretirement benefit costs  | (79 )                     | (65 )              | (74 )                  | (60 )              |
| <b>Total Shareholders' Equity</b>                    | <b>154,955</b>            | <b>152,513</b>     | <b>156,475</b>         | <b>149,916</b>     |
| <b>Total Liabilities &amp; Shareholders' Equity</b>  | <b>\$1,421,387</b>        | <b>\$1,429,056</b> | <b>\$1,419,503</b>     | <b>\$1,433,343</b> |





### Non-Interest Income

Non-interest income of \$8.6 million for the nine months ended September 30, 2012, is an increase of \$2.0 million compared to the same period in 2011. This increase was attributable to an increase in net securities gains. Non-interest income was \$2.5 million for the quarter ended September 30, 2012, an increase of 19.8% from the \$2.1 million reported for the quarter ended September 30, 2011. This increase was attributable to an increase in mortgage origination income resulting from higher levels of mortgage refinancing as well as an increase in investment management and fiduciary income.

### Non-Interest Expense

Non-interest expense of \$19.5 million for the nine months ended September 30, 2012 is a decrease of 0.8% or \$166,000 compared to non-interest expense of \$19.7 million for the same period in 2011. This decrease was attributable to lower costs for other real estate owned. Non-interest expense of \$6.6 million for the quarter ended September 30, 2012 is a decrease of 4.9% compared to non-interest expense of \$6.9 million for the same period in 2011. The Company's efficiency ratio was up slightly to 50.74% for the first nine months of 2012 compared 49.89% for the same period in 2011.

### Income Taxes

Income taxes on operating earnings were \$2.7 million for the nine months ended September 30, 2012, down \$246,000 from the same period in 2011. This is in line with the decrease in the Company's level of income before taxes and a higher level of tax-exempt income.

FASB ASC Topic 740 "Income Taxes" defines the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. Topic 740 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken, in order for those tax positions to be recognized in the financial statements. The Company is currently open to audit under the statute of limitations by the IRS for the years ended December 31, 2009 through 2011.

### Investments

The Company's investment portfolio increased by \$44.3 million or 10.4% between December 31, 2011, and September 30, 2012. The growth in the portfolio in the nine months of 2012 was primarily in GNMA mortgage-backed securities and U.S. Agency securities, which are fully backed by the U.S. Government and carry no credit risk. As of September 30, 2012, mortgage-backed securities had a carrying value of \$233.7 million and a fair value of \$237.1 million. Of this total, securities with a fair value of \$212.9 million or 89.6% of the mortgage-backed portfolio were issued by GNMA and securities with a fair value of \$4.6 million or 10.4% of the mortgage-backed portfolio were issued by FHLMC and FNMA.

The Company's investment securities are classified into two categories: securities available for sale and securities to be held to maturity. Securities available for sale consist primarily of debt securities which Management intends to hold for indefinite periods of time. They may be used as part of the Company's funds management strategy, and may be sold in response to changes in interest rates, prepayment risk and liquidity needs, to increase capital ratios, or for other similar reasons. Securities to be held to maturity consist primarily of debt securities that the Company has acquired solely for long-term investment purposes, rather than for trading or future sale. For securities to be categorized as held to maturity Management must have the intent and the Company must have the ability to hold such investments until their respective maturity dates. The Company does not hold trading account securities.

All investment securities are managed in accordance with a written investment policy adopted by the Board of Directors. It is the Company's general policy that investments for either portfolio be limited to government debt

obligations, time deposits, and corporate bonds or commercial paper with one of the three highest ratings given by a nationally recognized rating agency. The portfolio is currently invested primarily in U.S. Government agency securities and tax-exempt obligations of states and political subdivisions. The individual securities have been selected to enhance the portfolio's overall yield while not materially adding to the Company's level of interest rate risk.

Page 46

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The following table sets forth the Company's investment securities at their carrying amounts as of September 30, 2012 and 2011 and December 31, 2011.

| Dollars in thousands              | September<br>30, 2012 | December<br>31, 2011 | September<br>30, 2011 |
|-----------------------------------|-----------------------|----------------------|-----------------------|
| Securities available for sale     |                       |                      |                       |
| U.S. Treasury and agency          | \$-                   | \$-                  | \$ 16,494             |
| Mortgage-backed securities        | 189,437               | 198,232              | 235,038               |
| State and political subdivisions  | 108,955               | 85,726               | 74,039                |
| Corporate securities              | -                     | 811                  | 779                   |
| Other equity securities           | 1,508                 | 1,433                | 432                   |
|                                   | \$ 299,900            | \$ 286,202           | \$ 326,782            |
| Securities to be held to maturity |                       |                      |                       |
| U.S. Treasury and agency          | \$ 65,859             | \$ 19,390            | \$ 20,998             |
| Mortgage-backed securities        | 44,236                | 56,800               | 61,048                |
| State and political subdivisions  | 43,861                | 46,171               | 47,353                |
| Corporate securities              | 300                   | 300                  | 300                   |
|                                   | \$ 154,256            | \$ 122,661           | \$ 129,699            |
| Restricted equity securities      |                       |                      |                       |
| Federal Home Loan Bank Stock      | \$ 13,412             | \$ 14,031            | \$ 14,031             |
| Federal Reserve Bank Stock        | 1,036                 | 1,412                | 1,412                 |
|                                   | \$ 14,448             | \$ 15,443            | \$ 15,443             |
| Total securities                  | \$ 468,604            | \$ 424,306           | \$ 471,924            |

The following table sets forth yields and expected maturities of the Company's investment securities as of September 30, 2012. Yields on tax-exempt securities have been computed on a tax-equivalent basis using a tax rate of 35%. Mortgage-backed securities are presented according to their final contractual maturity date, while the calculated yield takes into effect the intermediate cash flows from repayment of principal which results in a much shorter average life.

| Dollars in thousands           | <u>Available For Sale</u> |                   | <u>Held to Maturity</u> |                   |   |
|--------------------------------|---------------------------|-------------------|-------------------------|-------------------|---|
|                                | Fair Value                | Yield to maturity | Amortized Cost          | Yield to maturity |   |
| U.S. Agency                    |                           |                   |                         |                   |   |
| Due in 1 year or less          | \$-                       | 0.00              | % \$-                   | 0.00              | % |
| Due in 1 to 5 years            | -                         | 0.00              | % -                     | 0.00              | % |
| Due in 5 to 10 years           | -                         | 0.00              | % -                     | 0.00              | % |
| Due after 10 years             | -                         | 0.00              | % 65,859                | 3.30              | % |
| Total                          | -                         | 0.00              | % 65,859                | 3.30              | % |
| Mortgage-Backed Securities     |                           |                   |                         |                   |   |
| Due in 1 year or less          | 3,634                     | 22.48             | % 6                     | 3.92              | % |
| Due in 1 to 5 years            | 49,504                    | 2.65              | % 5,814                 | 3.30              | % |
| Due in 5 to 10 years           | 16,813                    | 3.21              | % 5,436                 | 3.99              | % |
| Due after 10 years             | 119,486                   | 2.73              | % 32,980                | 4.53              | % |
| Total                          | 189,437                   | 3.13              | % 44,236                | 4.30              | % |
| State & Political Subdivisions |                           |                   |                         |                   |   |
| Due in 1 year or less          | 1,018                     | 6.90              | % 1,370                 | 6.22              | % |
| Due in 1 to 5 years            | 1,782                     | 6.90              | % 4,932                 | 6.55              | % |
| Due in 5 to 10 years           | 1,152                     | 6.17              | % 15,083                | 6.30              | % |
| Due after 10 years             | 105,003                   | 5.85              | % 22,476                | 6.27              | % |
| Total                          | 108,955                   | 5.88              | % 43,861                | 6.31              | % |
| Corporate Securities           |                           |                   |                         |                   |   |
| Due in 1 year or less          | -                         | 0.00              | % -                     | 0.00              | % |
| Due in 1 to 5 years            | -                         | 0.00              | % 300                   | 1.25              | % |
| Due in 5 to 10 years           | -                         | 0.00              | % -                     | 0.00              | % |
| Due after 10 years             | -                         | 0.00              | % -                     | 0.00              | % |
| Total                          | -                         | 0.00              | % 300                   | 1.25              | % |
| Equity Securities              | 1,508                     | 1.73              | % -                     | 0.00              | % |
|                                | \$299,900                 | 4.12              | % \$154,256             | 4.44              | % |

#### Impaired Securities

The securities portfolio contains certain securities that the amortized cost of which exceeds fair value, which at September 30, 2012 amounted to \$0.3 million, or 0.08% of the amortized cost of the total securities portfolio. At December 31, 2011 this amount was \$0.8 million, or 0.19% of the total securities portfolio. As a part of the Company's ongoing security monitoring process, the Company identifies securities in an unrealized loss position that could potentially be other-than-temporarily impaired. If a decline in the fair value of a debt security is judged to be other-than-temporary, the decline related to credit loss is recorded in net realized securities losses while the decline attributable to other factors is recorded in other comprehensive income or loss.

The Company's evaluation of securities for impairment is a quantitative and qualitative process intended to determine whether declines in the fair value of investment securities should be recognized in current period earnings. The primary factors considered in evaluating whether a decline in the fair value of securities is other-than-temporary include: (a) the length of time and extent to which the fair value has been less than cost or amortized cost and the expected recovery period of the security, (b) the financial condition, credit rating and future prospects of the issuer, (c) whether the debtor is current on contractually obligated interest and principal payments, (d) the volatility of the securities market price, (e) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for recovery, which may be at maturity, and (f) any other information and observable data considered relevant in determining whether other-than-temporary impairment has occurred.



The Company's best estimate of cash flows uses severe economic recession assumptions due to market uncertainty. The Company's assumptions include but are not limited to delinquencies, foreclosure levels and constant default rates on the underlying collateral, loss severity ratios, and constant prepayment rates. If the Company does not expect to receive 100% of future contractual principal and interest, an other-than-temporary impairment charge is recognized. Estimating future cash flows is a quantitative and qualitative process that incorporates information received from third party sources along with certain internal assumptions and judgments regarding the future performance of the underlying collateral.

As of September 30, 2012, the Company had temporarily impaired securities with a fair value of \$18.6 million and unrealized losses of \$0.3 million, as identified in the table below. This was down from December 31, 2011 as a result of a decrease in interest rates and a corresponding increase in value of investment securities. Securities in a continuous unrealized loss position more than twelve-months amounted to \$3.3 million as of September 30, 2012, compared with \$9.3 million at December 31, 2011. The Company has concluded that these securities were not other-than-temporarily impaired. This conclusion was based on the issuer's continued satisfaction of the securities obligations in accordance with their contractual terms and the expectation that the issuer will continue to do so, Management's intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in fair value which may be at maturity, the expectation that the Company will receive 100% of future contractual cash flows, as well as the evaluation of the fundamentals of the issuer's financial condition and other objective evidence. The following table summarizes temporarily impaired securities and their approximate fair values at September 30, 2012.

| Dollars in thousands             | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|----------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury and agency         | \$1,199             | \$ (21 )          | \$-               | \$ -              | \$1,199    | \$ (21 )          |
| Mortgage-backed securities       | 12,990              | (76 )             | 3,104             | (31 )             | 16,094     | (107 )            |
| State and political subdivisions | 1,123               | (22 )             | -                 | -                 | 1,123      | (22 )             |
| Corporate securities             | -                   | -                 | -                 | -                 | -          | -                 |
| Other equity securities          | 3                   | -                 | 191               | (104 )            | 194        | (104 )            |
|                                  | \$15,315            | \$ (119 )         | \$3,295           | \$ (135 )         | \$18,610   | \$ (254 )         |

The following information was considered in determining securities were not other-than-temporarily impaired:

Securities issued by U.S. Government-sponsored agencies and enterprises. As of September 30, 2012 there were \$21,000 of unrealized losses on these securities compared to no unrealized losses as of December 31, 2011. All of these securities were credit rated "AAA" or "AA+" by the major credit rating agencies. Management believes that securities issued by the U.S. Treasury bear no credit risk because they are backed by the full faith and credit of the United States and that securities issued by U.S. Government-sponsored agencies and enterprises have minimal credit risk, as these agencies and enterprises play a vital role in the nation's financial markets.

Mortgage-backed securities issued by U.S. Government agencies and U.S. Government-sponsored enterprises. As of September 30, 2012, there were \$107,000 of unrealized losses on these securities compared with \$181,000 at December 31, 2011. All of these securities were credit rated "AAA" or "AA+" by the major credit rating agencies. Management believes that securities issued by U.S. Government agencies bear no credit risk because they are backed by the full faith and credit of the United States and that securities issued by U.S. Government-sponsored enterprises have minimal credit risk, as these agencies and enterprises play a vital role in the nation's financial markets. Management believes that the unrealized losses at September 30, 2012 were attributable to changes in current market yields and spreads since the date the underlying securities were purchased, and does not consider these securities to be other-than-temporarily impaired at September 30, 2012. The Company also has the ability and intent to hold these securities until a recovery of their amortized cost, which may be at maturity.





Obligations of state and political subdivisions. As of September 30, 2012, the total unrealized losses on municipal securities amounted to \$22,000, compared with \$189,000 at December 31, 2011. Municipal securities are supported by the general taxing authority of the municipality and, in the cases of school districts, are supported by state aid. At September 30, 2012, all municipal bond issuers were current on contractually obligated interest and principal payments. The Company attributes the unrealized losses at September 30, 2012 to changes in prevailing market yields and pricing spreads since the date the underlying securities were purchased, combined with current market liquidity conditions and the disruption in the financial markets in general. Accordingly, the Company does not consider these municipal securities to be other-than-temporarily impaired at September 30, 2012. The Company also has the ability and intent to hold these securities until a recovery of their amortized cost, which may be at maturity.

Corporate securities. There were no unrealized losses on corporate securities as of September 30, 2012, compared with \$287,000 at December 31, 2011. Corporate securities are dependent on the operating performance of the issuers.

#### Federal Home Loan Bank Stock

The Bank is a member of the Federal Home Loan Bank ("FHLB") of Boston, a cooperatively owned wholesale bank for housing and finance in the six New England States. As a requirement of membership in the FHLB, the Bank must own a minimum required amount of FHLB stock, calculated periodically based primarily on its level of borrowings from the FHLB. The Bank uses the FHLB for much of its wholesale funding needs. As of September 30, 2012 and December 31, 2011, the Bank's investment in FHLB stock totaled \$13.4 million and \$14.0 million, respectively. FHLB stock is a non-marketable equity security and therefore is reported at cost, which equals par value.

#### Loans Held for Sale

Loans held for sale are carried at the lower of cost or market value. There were no loans held for sale at September 30, 2012 and December 31, 2011 compared to \$230,000 at September 30, 2011. No recourse obligations have been incurred in connection with the sale of loans.

#### Loans

The loan portfolio increased during the first nine months of 2012, with total loans at \$869.9 million at September 30, 2012, up \$4.9 million or 0.6% from total loans of \$865.0 million at December 31, 2011. Commercial loans decreased \$12.8 million or 3.4% between December 31, 2011 and September 30, 2012, municipal loans increased by \$227,000 or 1.4% and residential term loans increased \$28.7 million or 8.4%.

Commercial loans are comprised of three major classes, commercial real estate loans, commercial construction loans and other commercial loans. Commercial real estate is primarily comprised of loans to small businesses collateralized by owner-occupied real estate, while other commercial is primarily comprised of loans to small businesses collateralized by plant and equipment, commercial fishing vessels and gear, and limited inventory-based lending. Commercial real estate loans typically have a maximum loan-to-value of 75% based upon current appraisal information at the time the loan is made. Land and land development loans typically have a maximum loan-to-value of 65% to 75% based upon current appraisal information at the time the loan is made. Construction loans, both commercial and residential, comprise a very small portion of the portfolio, and at 21.7% of capital are well under the regulatory guidance of 100.0% of capital. Construction loans and non-owner-occupied commercial real estate loans are at 79.0% of total capital, well under the regulatory guidance of 300.0% of capital. Municipal loans are comprised of loans to municipalities in the State of Maine for capitalized expenditures, construction projects or tax-anticipation notes. All municipal loans are considered general obligations of the municipality and as such are collateralized by the taxing ability of the municipality for repayment of debt.

Residential loans are also comprised of two classes, term loans, which include traditional amortizing home mortgages, and construction loans, which include loans for owner-occupied residential construction. Residential loans typically have a 75% to 80% loan to value based upon current appraisal information at the time the loan is made. Consumer loans are primarily amortizing loans to individuals collateralized by automobiles, pleasure craft and recreation vehicles, typically with a maximum loan to value of 80% to 90% of the purchase price of the collateral. Consumer loans also include a small amount of unsecured short-term time notes to individuals.

Page 50

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The following table summarizes the loan portfolio, by class, at September 30, 2012 and 2011 and December 31, 2011.

| Dollars in thousands       | September 30,<br>2012 |         | December 31,<br>2011 |         | September 30,<br>2011 |         |
|----------------------------|-----------------------|---------|----------------------|---------|-----------------------|---------|
| Commercial                 |                       |         |                      |         |                       |         |
| Real estate                | \$256,531             | 29.5 %  | \$255,424            | 29.5 %  | \$257,910             | 29.7 %  |
| Construction               | 21,905                | 2.5 %   | 32,574               | 3.8 %   | 30,345                | 3.5 %   |
| Other                      | 83,703                | 9.6 %   | 86,982               | 10.1 %  | 96,045                | 11.1 %  |
| Municipal                  | 16,448                | 1.9 %   | 16,221               | 1.9 %   | 19,853                | 2.3 %   |
| Residential                |                       |         |                      |         |                       |         |
| Term                       | 369,949               | 42.5 %  | 341,286              | 39.5 %  | 329,730               | 38.0 %  |
| Construction               | 6,528                 | 0.8 %   | 10,469               | 1.2 %   | 12,061                | 1.4 %   |
| Home equity line of credit | 100,099               | 11.5 %  | 105,244              | 12.1 %  | 105,891               | 12.1 %  |
| Consumer                   | 14,708                | 1.7 %   | 16,788               | 1.9 %   | 16,738                | 1.9 %   |
| Total loans                | \$869,871             | 100.0 % | \$864,988            | 100.0 % | \$868,573             | 100.0 % |

The following table sets forth certain information regarding the contractual maturities of the Bank's loan portfolio as of September 30, 2012.

| Dollars in thousands       | < 1<br>Year | 1 - 5<br>Years | 5 - 10<br>Years | > 10<br>Years | Total     |
|----------------------------|-------------|----------------|-----------------|---------------|-----------|
| Commercial                 |             |                |                 |               |           |
| Real estate                | \$6,213     | \$23,511       | \$18,477        | \$208,330     | \$256,531 |
| Construction               | 7,091       | 2,238          | 25              | 12,551        | 21,905    |
| Other                      | 12,598      | 18,827         | 20,756          | 31,522        | 83,703    |
| Municipal                  | 1,136       | 3,814          | 5,704           | 5,794         | 16,448    |
| Residential                |             |                |                 |               |           |
| Term                       | 1,096       | 12,314         | 20,038          | 336,501       | 369,949   |
| Construction               | 2,454       | 642            | -               | 3,432         | 6,528     |
| Home equity line of credit | 1,281       | 293            | 803             | 97,722        | 100,099   |
| Consumer                   | 5,919       | 5,872          | 877             | 2,040         | 14,708    |
| Total loans                | \$37,788    | \$67,511       | \$66,680        | \$697,892     | \$869,871 |

The following table provides a listing of loans by class, between variable and fixed rates as of September 30, 2012.

| Dollars in thousands       | <u>Fixed-Rate</u> |               | <u>Adjustable-Rate</u> |               | <u>Total</u> |               |
|----------------------------|-------------------|---------------|------------------------|---------------|--------------|---------------|
|                            | Amount            | % of<br>total | Amount                 | % of<br>total | Amount       | % of<br>total |
| Commercial                 |                   |               |                        |               |              |               |
| Real estate                | \$40,655          | 4.7 %         | \$215,876              | 24.8 %        | \$256,531    | 29.5 %        |
| Construction               | 416               | 0.0 %         | 21,489                 | 2.5 %         | 21,905       | 2.5 %         |
| Other                      | 29,740            | 3.4 %         | 53,963                 | 6.2 %         | 83,703       | 9.6 %         |
| Municipal                  | 13,429            | 1.6 %         | 3,019                  | 0.3 %         | 16,448       | 1.9 %         |
| Residential                |                   |               |                        |               |              |               |
| Term                       | 179,132           | 20.6 %        | 190,817                | 21.9 %        | 369,949      | 42.5 %        |
| Construction               | 3,882             | 0.4 %         | 2,646                  | 0.4 %         | 6,528        | 0.8 %         |
| Home equity line of credit | 1,930             | 0.2 %         | 98,169                 | 11.3 %        | 100,099      | 11.5 %        |
| Consumer                   | 11,734            | 1.3 %         | 2,974                  | 0.4 %         | 14,708       | 1.7 %         |

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|             |           |       |           |       |           |        |
|-------------|-----------|-------|-----------|-------|-----------|--------|
| Total loans | \$280,918 | 32.2% | \$588,953 | 67.8% | \$869,871 | 100.0% |
|-------------|-----------|-------|-----------|-------|-----------|--------|

Page 51

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## Loan Concentrations

As of September 30, 2012, the Bank did not have any concentration of loans in one particular industry that exceeded 10% of its total loan portfolio.

## Credit Risk Management and Allowance for Loan Losses

Credit risk is the risk of loss arising from the inability of a borrower to meet its obligations. We manage credit risk by evaluating the risk profile of the borrower, repayment sources, the nature of the underlying collateral, and other support given current events, conditions, and expectations. We attempt to manage the risk characteristics of our loan portfolio through various control processes, such as credit evaluation of borrowers, establishment of lending limits, and application of lending procedures, including the holding of adequate collateral and the maintenance of compensating balances. However, we seek to rely primarily on the cash flow of our borrowers as the principal source of repayment. Although credit policies and evaluation processes are designed to minimize our risk, Management recognizes that loan losses will occur and the amount of these losses will fluctuate depending on the risk characteristics of our loan portfolio, as well as general and regional economic conditions.

We provide for loan losses through the establishment of an allowance for loan losses which represents an estimated reserve for existing losses in the loan portfolio. We deploy a systematic methodology for determining our allowance that includes a quarterly review process, risk rating, and adjustment to our allowance. We classify our portfolios as either commercial or residential and consumer and monitor credit risk separately as discussed below. We evaluate the appropriateness of our allowance continually based on a review of all significant loans, with a particular emphasis on nonaccruing, past due, and other loans that we believe require special attention.

The allowance consists of four elements: (1) specific reserves for loans evaluated individually for impairment; (2) general reserves for types or portfolios of loans based on historical loan loss experience; (3) qualitative reserves judgmentally adjusted for local and national economic conditions, concentrations, portfolio composition, volume and severity of delinquencies and nonaccrual loans, trends of criticized and classified loans, changes in credit policies, and underwriting standards, credit administration practices, and other factors as applicable; and (4) unallocated reserves. All outstanding loans are considered in evaluating the appropriateness of the allowance.

Appropriateness of the allowance for loan losses is determined using a consistent, systematic methodology, which analyzes the risk inherent in the loan portfolio. In addition to evaluating the collectability of specific loans when determining the appropriateness of the allowance for loan losses, Management also takes into consideration other factors such as changes in the mix and size of the loan portfolio, historic loss experience, the amount of delinquencies and loans adversely classified, economic trends, changes in credit policies, and experience, ability and depth of lending management. The appropriateness of the allowance for loan losses is assessed by an allocation process whereby specific reserve allocations are made against certain adversely classified loans, and general reserve allocations are made against segments of the loan portfolio which have similar attributes. The Company's historical loss experience, industry trends, and the impact of the local and regional economy on the Company's borrowers, are considered by Management in determining the appropriateness of the allowance for loan losses.

The allowance for loan losses is increased by provisions charged against current earnings. Loan losses are charged against the allowance when Management believes that the collectability of the loan principal is unlikely. Recoveries on loans previously charged off are credited to the allowance. While Management uses available information to assess possible losses on loans, future additions to the allowance may be necessary based on increases in non-performing loans, changes in economic conditions, growth in loan portfolios, or for other reasons. Any future additions to the allowance would be recognized in the period in which they were determined to be necessary. In addition, various regulatory agencies periodically review the Company's allowance for loan losses as an integral part of their examination process. Such agencies may require the Company to record additions to the allowance based on judgments different from those of Management.

Commercial

Our commercial portfolio includes all secured and unsecured loans to borrowers for commercial purposes, including commercial lines of credit and commercial real estate. Our process for evaluating commercial loans includes performing updates on loans that we have rated for risk. Our non-performing commercial loans are generally reviewed individually to determine impairment, accrual status, and the need for specific reserves. Our methodology incorporates a variety of risk considerations, both qualitative and quantitative. Quantitative factors include our historical loss experience by loan type, collateral values, financial condition of borrowers, and other factors. Qualitative factors

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include judgments concerning general economic conditions that may affect credit quality, credit concentrations, the pace of portfolio growth, and delinquency levels; these qualitative factors are also considered in connection with our unallocated portion of our allowance for loan losses.

The process of establishing the allowance with respect to our commercial loan portfolio begins when a loan officer initially assigns each loan a risk rating, using established credit criteria. Approximately 50% of our outstanding loans and commitments are subject to review and validation annually by an independent consulting firm, as well as periodically by our internal credit review function. Our methodology employs Management's judgment as to the level of losses on existing loans based on our internal review of the loan portfolio, including an analysis of the borrowers' current financial position, and the consideration of current and anticipated economic conditions and their potential effects on specific borrowers and or lines of business. In determining our ability to collect certain loans, we also consider the fair value of any underlying collateral. We also evaluate credit risk concentrations, including trends in large dollar exposures to related borrowers, industry and geographic concentrations, and economic and environmental factors.

#### Residential and Consumer

Consumer and residential mortgage loans are generally segregated into homogeneous pools with similar risk characteristics. Trends and current conditions in consumer and residential mortgage pools are analyzed and historical loss experience is adjusted accordingly. Quantitative and qualitative adjustment factors for the consumer and residential mortgage portfolios are consistent with those for the commercial portfolios. Certain loans in the consumer and residential portfolios identified as having the potential for further deterioration are analyzed individually to confirm the appropriate risk status and accrual status, and to determine the need for a specific reserve. Consumer loans that are greater than 120 days past due are generally charged off. Residential loans that are greater than 90 days past due are evaluated for collateral adequacy and if deficient are placed on non-accrual status.

#### Unallocated

The unallocated portion of the allowance is intended to provide for losses that are not identified when establishing the specific and general portions of the allowance and is based upon Management's evaluation of various conditions that are not directly measured in the determination of the portfolio and loan specific allowances. Such conditions include general economic and business conditions affecting our lending area, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes and concentrations, specific industry conditions within portfolio categories, recent loss experience in particular loan categories, duration of the current business cycle, bank regulatory examination results, findings of external loan review examiners, and Management's judgment with respect to various other conditions including loan administration and management and the quality of risk identification systems. Management reviews these conditions quarterly. We have risk management practices designed to ensure timely identification of changes in loan risk profiles; however, undetected losses may exist inherently within the loan portfolio. The judgmental aspects involved in applying the risk grading criteria, analyzing the quality of individual loans, and assessing collateral values can also contribute to undetected, but probable, losses.

The allowance for loan losses includes reserve amounts assigned to individual loans on the basis of loan impairment. Certain loans are evaluated individually and are judged to be impaired when Management believes it is probable that the Company will not collect all of the contractual interest and principal payments as scheduled in the loan agreement. Under this method, loans are selected for evaluation based on internal risk ratings or non-accrual status. A specific reserve is allocated to an individual loan when that loan has been deemed impaired and when the amount of a probable loss is estimable on the basis of its collateral value, the present value of anticipated future cash flows, or its net realizable value. At September 30, 2012, impaired loans with specific reserves totaled \$22.1 and the amount of such reserves was \$5.1 million. This compares to impaired loans with specific reserves of \$14.2 million at December 31, 2011 and the amount of such reserves was \$2.1 million.

All of these analyses are reviewed and discussed by the Directors' Loan Committee, and recommendations from these processes provide Management and the Board of Directors with independent information on loan portfolio condition. Our total allowance at September 30, 2012 is considered by Management to be appropriate to address the credit losses inherent in the loan portfolio at that date. Management views the level of the allowance for loan losses as appropriate. However, our determination of the appropriate allowance level is based upon a number of assumptions we make about future events, which we believe are reasonable, but which may or may not prove valid. Thus, there can be no assurance that our charge-offs in future periods will not exceed our allowance for loan losses or that we will not

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need to make additional increases in our allowance for loan losses.

The following table summarizes our allocation of allowance by loan class as of September 30, 2012 and 2011 and December 31, 2011. The percentages are the portion of each loan class to total loans.

| Dollars in thousands       | September 30,<br>2012 |        | December 31,<br>2011 |        | September 30,<br>2011 |        |
|----------------------------|-----------------------|--------|----------------------|--------|-----------------------|--------|
| Commercial                 |                       |        |                      |        |                       |        |
| Real estate                | \$5,695               | 29.5 % | \$5,659              | 29.5 % | \$7,456               | 29.7 % |
| Construction               | 1,059                 | 2.5 %  | 658                  | 3.8 %  | 804                   | 3.5 %  |
| Other                      | 2,632                 | 9.6 %  | 2,063                | 10.1 % | 2,901                 | 11.1 % |
| Municipal                  | 18                    | 1.9 %  | 19                   | 1.9 %  | 19                    | 2.3 %  |
| Residential                |                       |        |                      |        |                       |        |
| Term                       | 2,223                 | 42.5 % | 1,159                | 39.5 % | 1,444                 | 38.0 % |
| Construction               | 14                    | 0.8 %  | 255                  | 1.2 %  | 120                   | 1.4 %  |
| Home equity line of credit | 790                   | 11.5 % | 595                  | 12.1 % | 574                   | 12.1 % |
| Consumer                   | 548                   | 1.7 %  | 584                  | 1.9 %  | 615                   | 1.9 %  |
| Unallocated                | 1,760                 | 0.0 %  | 2,008                | 0.0 %  | 1,386                 | 0.0 %  |
| Total                      | \$14,739              | 100.0% | \$13,000             | 100.0% | \$15,319              | 100.0% |

The allowance for loan losses totaled \$14.7 million at September 30, 2012, compared to \$13.0 million and \$15.3 million as of December 31, 2011 and September 30, 2011, respectively. Management's ongoing application of methodologies to establish the allowance include an evaluation of impaired loans for specific reserves. These specific reserves increased \$3.0 million in the first nine months of 2012 from \$2.1 million at December 31, 2011 to \$5.1 million at September 30, 2012. The specific loans that make up those categories change from period to period. Impairment on those loans, which would be reflected in the allowance for loan losses, might or might not exist, depending on the specific circumstances of each loan. The portion of the reserve based upon homogeneous pools of loans decreased by \$152,000 in the first nine months of 2012. This was attributable to higher loss factors in the past two years, which results in higher reserves applied to these pools. The portion of the reserve based on qualitative factors decreased by \$865,000 during 2012 as a result of adjustments for several qualitative factors. Despite the shifts in specific, pooled and qualitative reserves, Management feels that market trends and other internal factors justified the \$248,000 decrease in unallocated reserves in the first nine months of 2012 from \$2.0 million at December 31, 2011 to \$1.8 million at September 30, 2012.

A breakdown of the allowance for loan losses as of September 30, 2012, by loan class and allowance element, is presented in the following table:

| Dollars in thousands | Specific<br>Reserves on<br>Loans<br>Evaluated<br>Individually<br>for<br>Impairment | General<br>Reserves<br>Based on<br>Historical<br>Loss<br>Experience | Reserves<br>for<br>Qualitative<br>Factors | Unallocated<br>Reserves | Total<br>Reserves |
|----------------------|--|---|---|-------------------------|-------------------|
| Commercial           |  |   |   |                         |                   |
| Real estate          | \$ 1,416   | \$ 2,479  | \$ 1,800                                  | \$ -                    | \$ 5,695          |
| Construction         | 696  | 210   | 153                                       | -                       | 1,059             |
| Other                | 1,240  | 807   | 585                                       | -                       | 2,632             |
| Municipal            | -  | -   | 18  | -                       | 18                |
| Residential          |  |   |   |                         |                   |

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|                            |          |          |          |          |           |
|----------------------------|----------|----------|----------|----------|-----------|
| Term                       | 1,494    | 293      | 436      | -        | 2,223     |
| Construction               | -        | 5        | 9        | -        | 14        |
| Home equity line of credit | 215      | 238      | 337      | -        | 790       |
| Consumer                   | 1        | 317      | 230      | -        | 548       |
| Unallocated                | -        | -        | -        | 1,760    | 1,760     |
|                            | \$ 5,062 | \$ 4,349 | \$ 3,568 | \$ 1,760 | \$ 14,739 |

Page 54

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Based upon Management's evaluation, provisions are made to maintain the allowance as a best estimate of inherent losses within the portfolio. The provision for loan losses to maintain the allowance was \$6.3 million for the first nine months of 2012, an increase of \$700,000 from the nine months of 2011. Net chargeoffs were \$4.6 million in the first nine months of 2012 compared to net chargeoffs of \$3.6 million in the first nine months of 2011. Our allowance as a percentage of outstanding loans has increased from 1.50% as of December 31, 2011 to 1.69% as of September 30, 2012, reflecting the changes in our loss estimates and the increases resulting from the application of our loss estimate methodology.

The following table summarizes the activities in our allowance for loan losses for the nine months ended September 30, 2012 and 2011 and for the year ended December 31, 2011:

|  | September<br>30,<br>2012 | December<br>31,<br>2011 | September<br>30,<br>2011 |   |
|--|--------------------------|-------------------------|--------------------------|---|
| Dollars in thousands   |                          |                         |                          |   |
| Balance at beginning of year   | \$ 13,000                | \$ 13,316               | \$ 13,316                |   |
| Loans charged off:   |                          |                         |                          |   |
| Commercial   |                          |                         |                          |   |
| Real estate  | 1,101                    | 1,619                   | 835                      |   |
| Construction   | 87                       | 346                     | -                        |   |
| Other  | 2,168                    | 6,492                   | 942                      |   |
| Municipal  | -                        | -                       | -                        |   |
| Residential  |                          |                         |                          |   |
| Term   | 554                      | 1,421                   | 1,013                    |   |
| Construction   | 381                      | 505                     | 505                      |   |
| Home equity line of credit   | 391                      | 415                     | 240                      |   |
| Consumer   | 382                      | 381                     | 298                      |   |
| Total  | 5,064                    | 11,179                  | 3,833                    |   |
| Recoveries on loans previously charged off                               |                          |                         |                          |   |
| Commercial   |                          |                         |                          |   |
| Real estate  | 4                        | 23                      | 8                        |   |
| Construction   | 247                      | -                       | -                        |   |
| Other  | 50                       | 60                      | 33                       |   |
| Municipal  | -                        | -                       | -                        |   |
| Residential  |                          |                         |                          |   |
| Term   | 3                        | 7                       | 5                        |   |
| Construction   | 42                       | -                       | -                        |   |
| Home equity line of credit   | -                        | 1                       | 1                        |   |
| Consumer   | 157                      | 222                     | 189                      |   |
| Total  | 503                      | 313                     | 236                      |   |
| Net loans charged off  | 4,561                    | 10,866                  | 3,597                    |   |
| Provision for loan losses  | 6,300                    | 10,550                  | 5,600                    |   |
| Balance at end of period   | \$ 14,739                | \$ 13,000               | \$ 15,319                |   |
| Ratio of net loans charged off to average loans outstanding <sup>1</sup> | 0.70                     | % 1.23                  | % 0.54                   | % |
| Ratio of allowance for loan losses to total loans outstanding            | 1.69                     | % 1.50                  | % 1.76                   | % |

<sup>1</sup> Ratios for September 2012 and 2011 have been annualized on a 366-day basis and 365-day basis, respectively.

Management believes the allowance for loan losses is appropriate as of September 30, 2012. In Management's opinion, the level of the provision for loan losses and the corresponding decrease in the allowance for loan losses is directionally consistent with the overall credit quality of our loan portfolio and corresponding levels of nonperforming

loans and unallocated reserves, as well as with the performance of the national and local economies, higher levels of unemployment and the outlook for the recession continuing for some time to come.

## Nonperforming Loans

Nonperforming loans are comprised of loans, for which based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement or when principal and interest is 90 days or more past due unless the loan is both well secured and in the process of collection (in which case the loan may continue to accrue interest in spite of its past due status). A loan is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. A loan is "in the process of collection" if collection of the loan is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

When a loan becomes nonperforming (generally 90 days past due), it is evaluated for collateral dependency based upon the most recent appraisal or other evaluation method. If the collateral value is lower than the outstanding loan balance plus accrued interest and estimated selling costs, the loan is placed on non-accrual status, all accrued interest is reversed from interest income, and a specific reserve is established for the difference between the loan balance and the collateral value less selling costs. Concurrently, a new appraisal or valuation may be ordered, depending on collateral type, currency of the most recent valuation, the size of the loan, and other factors appropriate to the loan. Upon receipt and acceptance of the new valuation, the loan may have an additional specific reserve or write down based on the updated collateral value. On an ongoing basis, appraisals or valuations may be done periodically on collateral dependent non-performing loans and an additional specific reserve or write down will be made, if appropriate, based on the new collateral value.

Once a loan is placed on nonaccrual, it remains in nonaccrual status until the loan is current as to payment of both principal and interest and the borrower demonstrates the ability to pay and remain current. All payments made on nonaccrual loans are applied to the principal balance of the loan.

Nonperforming loans, expressed as a percentage of total loans, totaled 2.71% at September 30, 2012 compared to 3.21% at December 31, 2011 and 2.42% at September 30, 2011. The following table shows the distribution of nonperforming loans by class as of September 30, 2012 and 2011 and December 31, 2011:

| Dollars in thousands   | September<br>30, 2012 | December<br>31, 2011 | September<br>30, 2011 |
|--|-----------------------|----------------------|-----------------------|
| Commercial   |                       |                      |                       |
| Real estate  | \$ 5,483              | \$ 7,064             | \$ 6,056              |
| Construction   | 3,546                 | 2,350                | 792                   |
| Other  | 3,030                 | 5,836                | 1,398                 |
| Municipal  | -                     | -                    | -                     |
| Residential  |                       |                      |                       |
| Term   | 12,187                | 11,312               | 12,286                |
| Construction   | 23                    | 1,198                | 396                   |
| Home equity line of credit   | 1,028                 | 1,163                | 1,234                 |
| Consumer   | 63                    | 53                   | 109                   |
| Non-performing loans plus loans 90 or more days past due and still accruing interest | \$ 25,360             | \$ 28,976            | \$ 22,271             |
| Non-performing loans included in above total   | \$ 23,573             | \$ 27,806            | \$ 20,980             |

Total nonperforming loans does not include loans 90 or more days past due and still accruing interest. These are loans in which we expect to collect all amounts due, including past-due interest. As of September 30, 2012, loans 90 or more days past due and still accruing interest totaled \$1.8 million, compared to \$1.2 million and \$1.3 million at

December 31, 2011 and September 30, 2011, respectively.

Page 56

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## Troubled Debt Restructured

A troubled debt restructured ("TDR") constitutes a restructuring of debt if the Bank, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. To determine whether or not a loan should be classified as a TDR, Management evaluates a loan based upon the following criteria:

The borrower demonstrates financial difficulty; common indicators include past due status with bank obligations, substandard credit bureau reports, or an inability to refinance with another lender, and

The Bank has granted a concession; common concession types include maturity date extension, interest rate adjustments to below market pricing, and deferment of payments.

As of September 30, 2012 we had 91 loans with a value of \$29.3 million that have been restructured. This compares to 45 loans with a value of \$10.5 million classified as TDRs as of September 30, 2011. As of September 30, 2012, Management is aware of four loans classified as TDRs that are involved in bankruptcy with an outstanding balance of \$712,000. There were also 29 loans with an outstanding balance of \$4.3 million that were classified as TDRs and on non-accrual status four of which, with an outstanding balance of \$574,000, were in the process of foreclosure.

## Impaired Loans

Impaired loans include restructured loans and loans placed on non-accrual status. These loans are measured at the present value of expected future cash flows discounted at the loan's effective interest rate or at the fair value of the collateral if the loan is collateral dependent. If the measure of an impaired loan is lower than the recorded investment in the loan and estimated selling costs, a specific reserve is established for the difference. Impaired loans totaled \$48.6 million at September 30, 2012, and have increased \$6.5 million from December 31, 2011. The number of loans increased by 21 from 211 to 232 during the same period. Impaired commercial loans increased \$5.0 million from December 31, 2011 to September 30, 2012. The specific allowance for impaired commercial loans increased from \$1.2 million at December 31, 2011 to \$3.4 as of September 30, 2012, which represented the fair value deficiencies for loans where the fair value of the collateral was estimated at less than our carrying amount of the loan. From December 31, 2011 to September 30, 2012, impaired residential loans increased \$1.3 million, impaired home equity lines of credit increased \$282,000, and impaired consumer loans decreased \$52,000.

The following table sets forth impaired loans as of September 30, 2012 and 2011 and December 31, 2011:

| Dollars in thousands       | September<br>30, 2012 | December<br>31, 2011 | September<br>30, 2011 |
|----------------------------|-----------------------|----------------------|-----------------------|
| Commercial                 |                       |                      |                       |
| Real estate                | \$ 16,321             | \$ 10,141            | \$ 7,739              |
| Construction               | 6,645                 | 5,702                | 792                   |
| Other                      | 4,905                 | 7,042                | 1,940                 |
| Municipal                  | -                     | -                    | -                     |
| Residential                |                       |                      |                       |
| Term                       | 19,305                | 16,821               | 16,067                |
| Construction               | 23                    | 1,198                | 396                   |
| Home equity line of credit | 1,445                 | 1,163                | 1,234                 |
| Consumer                   | 1                     | 53                   | 102                   |
| Total                      | \$ 48,645             | \$ 42,120            | \$ 28,270             |

## Past Due Loans

The Bank's overall loan delinquency ratio was 2.27% at September 30, 2012, versus 3.07% at December 31, 2011 and 2.21% at September 30, 2011. Loans 90 days delinquent and accruing increased from \$1.2 million at December 31, 2011 to \$1.8 million as of September 30, 2012. The total at September 30, 2012, is made up of nine loans, with the largest loan totaling \$1.1 million. We expect to collect all amounts due on these loans, plus any accrued interest. The following table sets forth loan delinquencies as of September 30, 2012 and 2011 and December 31, 2011:

| Dollars in thousands                                  | September<br>30,<br>2012 | December<br>31, 2011 | September<br>30,<br>2011 |   |  |
|---|--------------------------|----------------------|--------------------------|---|--|
| Commercial  |                          |                      |                          |   |  |
| Real estate   | \$ 2,397                 | \$ 6,864             | \$ 5,115                 |   |  |
| Construction  | 185                      | 1,777                | 35                       |   |  |
| Other   | 2,486                    | 2,623                | 1,777                    |   |  |
| Municipal   | -                        | -                    | -                        |   |  |
| Residential   |                          |                      |                          |   |  |
| Term  | 13,019                   | 12,174               | 10,173                   |   |  |
| Construction  | 23                       | 1,198                | 396                      |   |  |
| Home equity line of credit                            | 1,358                    | 1,614                | 1,479                    |   |  |
| Consumer  | 251                      | 347                  | 147                      |   |  |
| Total   | \$ 19,719                | \$ 26,597            | \$ 19,122                |   |  |
| Loans 30-89 days past due to total loans              | 0.64                     | % 1.00               | % 0.61                   | % |  |
| Loans 90+ days past due and accruing to total loans   | 0.21                     | % 0.14               | % 0.15                   | % |  |
| Loans 90+ days past due on non-accrual to total loans | 1.42                     | % 1.93               | % 1.45                   | % |  |
| Total past due loans to total loans                   | 2.27                     | % 3.07               | % 2.21                   | % |  |

## Potential Problem Loans and Loans in Process of Foreclosure

Potential problem loans consist of classified accruing commercial and commercial real estate loans that were between 30 and 89 days past due. Such loans are characterized by weaknesses in the financial condition of borrowers or collateral deficiencies. Based on historical experience, the credit quality of some of these loans may improve due to changes in collateral values or the financial condition of the borrowers, while the credit quality of other loans may deteriorate, resulting in some amount of loss. At September 30, 2012, there were 8 potential problem loans with a balance of \$1.1 million or 0.1% of total loans. This compares to 28 loans with a balance of \$4.7 million or 0.5% of total loans at December 31, 2011.

As of September 30, 2012, there were 39 loans in the process of foreclosure with a total balance of \$6.2 million. The Bank's foreclosure process begins when a loan becomes 45 days past due at which time a preliminary foreclosure letter is sent to the borrower. If the loan becomes 80 days past due, copies of the promissory note and mortgage deed are forwarded to the Bank's attorney for review and an affidavit for a Motion for Summary Judgment is then prepared. An authorized Bank officer signs the affidavit certifying the validity of the documents and verification of the past due amount which is then forwarded to the court. Once a Motion for Summary Judgment is granted, a Period of Redemption (POR) begins which gives the customer 90 days to cure the default. A foreclosure auction date is then set 30 days from the POR expiration date if the default is not cured.

In October 2011, the Bank conducted a self-audit of its loans in foreclosure and its foreclosure process and found there were no deficiencies or areas to improve. For loans sold to the secondary market on which servicing is retained, the Bank follows Freddie Mac's and Fannie Mae's published guidelines and regularly reviews these guidelines for updates and changes to process. All secondary market loans have been sold without recourse in a non-securitized, one-on-one



basis. As a result, the Bank has no liability for these loans in the event of a foreclosure.

Page 58

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## Other Real Estate Owned

Other real estate owned and repossessed assets ("OREO") are comprised of properties or other assets acquired through a foreclosure proceeding, or acceptance of a deed or title in lieu of foreclosure. Real estate acquired through foreclosure is carried at the lower of fair value less estimated cost to sell or the cost of the asset and is not included as part of the allowance for loan loss totals. At September 30, 2012, there were 27 properties owned with a net OREO balance of \$5.5 million, net of an allowance for losses of \$0.5 million, compared to December 31, 2011 when there were 16 properties owned with a net OREO balance of \$4.1 million, net of an allowance for losses of \$0.4 million and September 30, 2011 when there were 21 properties owned with a net OREO balance of \$6.3 million, net of an allowance for losses of \$0.6 million.

The following table presents the composition of other real estate owned:

| Dollars in thousands       | September<br>30, 2012 | December<br>31, 2011 | September<br>30, 2011 |
|----------------------------|-----------------------|----------------------|-----------------------|
| Carrying Value             |                       |                      |                       |
| Commercial                 |                       |                      |                       |
| Real estate                | \$ -                  | \$ -                 | \$ -                  |
| Construction               | 869                   | 59                   | 59                    |
| Other                      | 2,742                 | 1,504                | 2,747                 |
| Municipal                  | -                     | -                    | -                     |
| Residential                |                       |                      |                       |
| Term                       | 2,339                 | 2,967                | 4,106                 |
| Construction               | -                     | -                    | -                     |
| Home equity line of credit | -                     | -                    | -                     |
| Consumer                   | -                     | -                    | -                     |
| Total                      | \$ 5,950              | \$ 4,530             | \$ 6,912              |
| Related Allowance          |                       |                      |                       |
| Commercial                 |                       |                      |                       |
| Real estate                | \$ -                  | \$ -                 | \$ -                  |
| Construction               | -                     | -                    | -                     |
| Other                      | 309                   | 127                  | 142                   |
| Municipal                  | -                     | -                    | -                     |
| Residential                |                       |                      |                       |
| Term                       | 170                   | 309                  | 460                   |
| Construction               | -                     | -                    | -                     |
| Home equity line of credit | -                     | -                    | -                     |
| Consumer                   | -                     | -                    | -                     |
| Total                      | \$ 479                | \$ 436               | \$ 602                |
| Net Value                  |                       |                      |                       |
| Commercial                 |                       |                      |                       |
| Real estate                | \$ -                  | \$ -                 | \$ -                  |
| Construction               | 869                   | 59                   | 59                    |
| Other                      | 2,433                 | 1,377                | 2,605                 |
| Municipal                  | -                     | -                    | -                     |
| Residential                |                       |                      |                       |
| Term                       | 2,169                 | 2,658                | 3,646                 |
| Construction               | -                     | -                    | -                     |
| Home equity line of credit | -                     | -                    | -                     |

|          |          |          |          |
|----------|----------|----------|----------|
| Consumer | -        | -        | -        |
| Total    | \$ 5,471 | \$ 4,094 | \$ 6,310 |

## Goodwill

On January 14, 2005, the Company acquired FNB Bankshares of Bar Harbor, Maine, and its subsidiary, The First National Bank of Bar Harbor, which was merged into the Bank. The total value of the transaction was \$48.0 million, and all of the voting equity interest of FNB Bankshares was acquired in the transaction. As of December 31, 2011, the Company completed its annual review of goodwill and determined there has been no impairment.

## Liquidity Management

As of September 30, 2012, the Bank had primary sources of liquidity of \$281.9 million. It is Management's opinion this is adequate. The Bank has an additional \$297.4 million in contingent sources of liquidity, including the Federal Reserve Borrower in Custody program, municipal and corporate securities, and correspondent bank lines of credit. The Asset/Liability Committee ("ALCO") establishes guidelines for liquidity in its Asset/Liability policy and monitors internal liquidity measures to manage liquidity exposure. Based on its assessment of the liquidity considerations described above, Management believes the Company's sources of funding will meet anticipated funding needs.

Liquidity is the ability of a financial institution to meet maturing liability obligations and customer loan demand. The Bank's primary source of liquidity is deposits, which funded 70.4% of total average assets in the first nine months of 2012. While the generally preferred funding strategy is to attract and retain low-cost deposits, the ability to do so is affected by competitive interest rates and terms in the marketplace. Other sources of funding include discretionary use of purchased liabilities (e.g., FHLB term advances and other borrowings), cash flows from the securities portfolios and loan repayments. Securities designated as available for sale may also be sold in response to short-term or long-term liquidity needs although Management has no intention to do so at this time.

The Bank has a detailed liquidity funding policy and a contingency funding plan that provide for the prompt and comprehensive response to unexpected demands for liquidity. Management has developed quantitative models to estimate needs for contingent funding that could result from unexpected outflows of funds in excess of "business as usual" cash flows. In Management's estimation, risks are concentrated in two major categories: runoff of in-market deposit balances and the inability to renew wholesale sources of funding. Of the two categories, potential runoff of deposit balances would have the most significant impact on contingent liquidity. Our modeling attempts to quantify deposits at risk over selected time horizons. In addition to these unexpected outflow risks, several other "business as usual" factors enter into the calculation of the adequacy of contingent liquidity including payment proceeds from loans and investment securities, maturing debt obligations and maturing time deposits. The Bank has established collateralized borrowing capacity with the Federal Reserve Bank of Boston and also maintains additional collateralized borrowing capacity with the FHLB in excess of levels used in the ordinary course of business as well as Fed Funds lines with two correspondent banks and availability through the Federal Reserve Bank Borrower in Custody program.

## Deposits

During the first nine months of 2012, total deposits increased by \$3.2 million or 0.3% from December 31, 2011 levels. Low-cost deposits (demand, NOW, and savings accounts) increased by \$43.2 million or 13.8% in the first nine months of 2012, money market deposits decreased \$4.2 million or 5.3%, and certificates of deposit decreased \$35.8 million or 6.5%. Between September 30, 2011 and September 30, 2012, total deposits decreased by \$60.3 million or 6.0%. Low-cost deposits increased by \$23.3 million or 7.0%, money market accounts decreased \$2.9 million or 3.8%, and certificates of deposit decreased \$80.7 million or 13.6%. The majority of the change in certificates of deposit, both year-to-date and year-over-year, was the result from a shift in funding between borrowed funds and certificates of deposit. The increase in low-cost deposits year-over-year is higher than the usual seasonal flow we experience each year in our marketplace.

## Borrowed Funds

The Company uses funding from the Federal Home Loan Bank of Boston, the Federal Reserve Bank of Boston and repurchase agreements, enabling it to grow its balance sheet and its revenues. It may also be used to balance seasonal deposit flows or to carry out interest rate risk management strategies, and is increased to replace or supplement other sources of funding, including core deposits and certificates of deposit. During the nine months ended September 30, 2012, borrowed funds increased \$39.1 million or 14.7% from December 31, 2011. Between September 30, 2011 and September 30, 2012, borrowed funds increased by \$49.1 million or 19.2%. This increase was due to the shift in funding mentioned above.

Page 60

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## Shareholders' Equity

Shareholders' equity as of September 30, 2012 was \$156.6 million, compared to \$150.9 million as of December 31, 2011 and \$150.5 million as of September 30, 2011. The Company's earnings in the first nine months of 2012, net of dividends paid, added to shareholders' equity. The net unrealized gain on available-for-sale securities, presented in accordance with FASB ASC Topic 740 "Investments – Debt and Equity Securities", increased by \$2.1 million from December 31, 2011.

A cash dividend of 19.5 cents per share was declared in the third quarter of 2012, equal to the dividend declared in each of the past sixteen quarters. The dividend payout ratio, which is calculated by dividing dividends declared per share by diluted earnings per share, was 64.29% for the first nine months of 2012 compared to 68.82% for the same period in 2011. In determining future dividend payout levels, the Board of Directors carefully analyzes capital requirements and earnings retention, as set forth in the Company's Dividend Policy. The ability of the Company to pay cash dividends to its shareholders depends on receipt of dividends from its subsidiary, the Bank. The subsidiary may pay dividends to its parent out of so much of its net profits as the Bank's directors deem appropriate, subject to the limitation that the total of all dividends declared by the Bank in any calendar year may not exceed the total of its net profits of that year combined with its retained net profits of the preceding two years. The amount available for dividends in 2012 is this year's net income plus \$7.0 million.

On November 21, 2008, the Company received approval for a \$25 million investment in Fixed Rate Cumulative Perpetual Preferred Stock, Series A, by the U.S. Treasury under the Capital Purchase Program ("the CPP Shares"). The Company completed the CPP investment transaction on January 9, 2009. The CPP Shares call for cumulative dividends at a rate of 5.0% per year for the first five years, and at a rate of 9.0% per year in following years. The CPP Shares qualify as Tier 1 capital on the Company's books for regulatory purposes and rank senior to the Company's common stock and senior or at an equal level in the Company's capital structure to any other shares of preferred stock the Company may issue in the future.

On August 24, 2011, the Company repurchased \$12.5 million of the CPP Shares. The repurchase transaction was approved by the Federal Reserve Bank of Boston, the Company's primary regulator, as well as the Bank's primary regulator, the Office of the Comptroller of the Currency. These approvals were based on the Company's and the Bank's continued strong capital ratios after the repayment, and almost all of the repayment was made from retained earnings accumulated since the preferred stock was issued in 2009. After the repurchase, \$12.5 million of CPP Shares remains outstanding. The warrant issued in conjunction with the CPP Shares for 225,904 shares of Common Stock at an exercise price of \$16.60 per share was unchanged as a result of the repurchase transaction and remains outstanding. Regulatory leverage capital ratios for the Company were 8.60% and 8.32% at September 30, 2012 and December 31, 2011, respectively. The Company had a tier one risk-based capital ratio of 15.00% and a tier two risk-based capital ratio of 16.25% at September 30, 2012, compared to 14.40% and 15.66%, respectively, at December 31, 2011. These ratios are comfortably above the standards to be rated "well-capitalized" by regulatory authorities – qualifying for lower deposit-insurance premiums.

## Off-Balance Sheet Financial Instruments

No material off-balance sheet risk exists that requires a separate liability presentation.

## Contractual Obligations

The following table sets forth the contractual obligations of the Company as of September 30, 2012:

| Dollars in thousands | Total | Less than<br>1 year | 1-3 years | 3-5<br>years | More<br>than 5 |
|----------------------|-------|---------------------|-----------|--------------|----------------|
|----------------------|-------|---------------------|-----------|--------------|----------------|

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|   |           |           |           |          | years    |
|---|-----------|-----------|-----------|----------|----------|
| Borrowed funds                                    | \$304,749 | \$164,592 | \$40,000  | \$60,000 | \$40,157 |
| Operating leases                                  | 496       | 34        | 157       | 136      | 169      |
| Certificates of deposit                           | 513,416   | 292,598   | 188,494   | 32,324   | -        |
| Total   | \$818,661 | \$457,224 | \$228,651 | \$92,460 | \$40,326 |
| Total loan commitments and unused lines of credit | \$109,226 | \$109,226 | \$-       | \$-      | \$-      |

Page 61

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Item 3 – Quantitative and Qualitative Disclosures About Market Risk

## Market-Risk Management

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates. The First Bancorp, Inc.'s market risk is composed primarily of interest rate risk. The Bank's Asset/Liability Committee (ALCO) is responsible for reviewing the interest rate sensitivity position of the Company and establishing policies to monitor and limit exposure to interest rate risk. All guidelines and policies established by ALCO have been approved by the Board of Directors.

## Asset/Liability Management

The primary goal of asset/liability management is to maximize net interest income within the interest rate risk limits set by ALCO. Interest rate risk is monitored through the use of two complementary measures: static gap analysis and earnings simulation modeling. While each measurement has limitations, taken together they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Company, the level of risk through time, and the amount of exposure to changes in certain interest rate relationships.

Static gap analysis measures the amount of repricing risk embedded in the balance sheet at a point in time. It does so by comparing the differences in the repricing characteristics of assets and liabilities. A gap is defined as the difference between the principal amount of assets and liabilities that reprice within a specified time period. The Company's cumulative one-year gap at September 30, 2012 was +17.44% of total assets compared to +1.55% of total assets at December 31, 2011. Core deposits with non-contractual maturities are presented based upon historical patterns of balance attrition and pricing behavior, which are reviewed at least annually.

The gap repricing distributions include principal cash flows from residential mortgage loans and mortgage-backed securities in the time frames in which they are expected to be received. Mortgage prepayments are estimated by applying industry median projections of prepayment speeds to portfolio segments based on coupon range and loan age.

A summary of the Company's static gap, as of September 30, 2012, is presented in the following table:

|   | 0-90     | 90-365    | 1-5        | 5+          |
|---|----------|-----------|------------|-------------|
| Dollars in thousands                                  | Days     | Days      | Years      | Years       |
| Investment securities at amortized cost               | \$34,057 | \$120,713 | \$135,011  | \$149,778   |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 13,412   | -         | -          | 1,036       |
| Loans held for sale                                   | -        | -         | -          | -           |
| Loans   | 443,940  | 157,325   | 213,463    | 55,143      |
| Other interest-earning assets                         | -        | 10,435    | -          | -           |
| Non-rate-sensitive assets                             | 9,175    | -         | -          | 79,828      |
| Total assets  | 500,584  | 288,473   | 348,474    | 285,785     |
| Interest-bearing deposits                             | 239,554  | 129,077   | 220,953    | 265,463     |
| Borrowed funds  | 164,592  | -         | 100,000    | 40,157      |
| Non-rate-sensitive liabilities and equity             | 1,900    | 5,700     | 32,350     | 223,570     |
| Total liabilities and equity                          | 406,046  | 134,777   | 353,303    | 529,190     |
| Period gap  | \$94,538 | \$153,696 | \$(4,829 ) | \$(243,405) |
| Percent of total assets                               | 6.64 %   | 10.80 %   | -0.34 %    | -17.10 %    |
| Cumulative gap (current)                              | \$94,538 | \$248,234 | \$243,405  | \$-         |
| Percent of total assets                               | 6.64 %   | 17.44 %   | 17.10 %    | 0.00 %      |



The earnings simulation model forecasts capture the impact of changing interest rates on one-year and two-year net interest income. The modeling process calculates changes in interest income received and interest expense paid on all interest-earning assets and interest-bearing liabilities reflected on the Company's balance sheet. None of the assets used in the simulation are held for trading purposes. The modeling is done for a variety of scenarios that incorporate changes in the absolute level of interest rates as well as basis risk, as represented by changes in the shape of the yield curve and changes in interest rate relationships. Management evaluates the effects on income of alternative interest rate

Page 62

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scenarios against earnings in a stable interest rate environment. This analysis is also most useful in determining the short-run earnings exposures to changes in customer behavior involving loan payments and deposit additions and withdrawals.

The Company's most recent simulation model projects net interest income would decrease by approximately 1.09% of stable-rate net interest income if short-term rates affected by Federal Open Market Committee actions fall gradually by one percentage point over the next year, and increase by approximately 1.05% if rates rise gradually by two percentage points. Both scenarios are well within ALCO's policy limit of a decrease in net interest income of no more than 10.0% given a 2.0% move in interest rates, up or down. Management believes this reflects a reasonable interest rate risk position. In year two, and assuming no additional movement in rates, the model forecasts that net interest income would be lower than that earned in a stable rate environment by 7.10% in a falling-rate scenario, and higher than that earned in a stable rate environment by 0.62% in a rising rate scenario, when compared to the year-one base scenario. A summary of the Bank's interest rate risk simulation modeling, as of September 30, 2012 and December 31, 2011 is presented in the following table:

| Changes in Net Interest Income             | September 30, 2012 | December 31, 2011 |
|--|--------------------|-------------------|
| Year 1                                     |                    |                   |
| Projected change if rates decrease by 1.0% | -1.09%             | -0.80%            |
| Projected change if rates increase by 2.0% | 1.05%              | -0.40%            |
| Year 2                                     |                    |                   |
| Projected change if rates decrease by 1.0% | -7.10%             | -7.60%            |
| Projected change if rates increase by 2.0% | 0.62%              | -1.00%            |

This dynamic simulation model includes assumptions about how the balance sheet is likely to evolve through time and in different interest rate environments. Loans and deposits are projected to maintain stable balances. All maturities, calls and prepayments in the securities portfolio are assumed to be reinvested in similar assets. Mortgage loan prepayment assumptions are developed from industry median estimates of prepayment speeds for portfolios with similar coupon ranges and seasoning. Non-contractual deposit volatility and pricing are assumed to follow historical patterns. The sensitivities of key assumptions are analyzed annually and reviewed by ALCO.

This sensitivity analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions including, among others, the nature and timing of interest rate levels, yield curve shape, prepayments on loans and securities, pricing decisions on loans and deposits, and reinvestment/ replacement of asset and liability cash flows. While assumptions are developed based upon current economic and local market conditions, the Company cannot make any assurances as to the predictive ability of these assumptions, including how customer preferences or competitor influences might change.

#### Interest Rate Risk Management

A variety of financial instruments can be used to manage interest rate sensitivity. These may include investment securities, interest rate swaps, and interest rate caps and floors. Frequently called interest rate derivatives, interest rate swaps, caps and floors have characteristics similar to securities but possess the advantages of customization of the risk-reward profile of the instrument, minimization of balance sheet leverage and improvement of liquidity. As of September 30, 2012, the Company was using no interest rate derivatives for interest rate risk management.

The Company engages an independent consultant to periodically review its interest rate risk position, as well as the effectiveness of simulation modeling and reasonableness of assumptions used. As of September 30, 2012, there were no significant differences between the views of the independent consultant and Management regarding the Company's interest rate risk exposure. As a result of recent statements made by the Federal Open Market Committee, Management expects interest rates will remain stable in the next ten-to-twelve quarters and believes that the current

level of interest rate risk is acceptable.

Page 63

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Item 4: Controls and Procedures

As required by Rule 13a-15 under the Securities Exchange Act of 1934, as of September 30, 2012, the end of the quarter covered by this report, the Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. In designing and evaluating the Company's disclosure controls and procedures, the Company and its management recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and the Company's management necessarily was required to apply its judgment in evaluating and implementing possible controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. There was no change in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company reviews its disclosure controls and procedures, which may include its internal controls over financial reporting on an ongoing basis, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that the Company's systems evolve with its business.

Page 64

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Part II – Other Information

Item 1 – Legal Proceedings

The Company was not involved in any legal proceedings requiring disclosure under Item 103 of Regulation S-K during the reporting period.

Item 1A – Risk Factors

There have been no material changes from the risk factors previously disclosed in the Company's Form 10-K for the year ended December 31, 2011.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

a. None

b. None

c. None

Item 3 – Default Upon Senior Securities

None.

Item 4 – Other Information

A. None.

B. None.

Page 65

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Item 5 – Exhibits

Exhibit 2.1 Agreement and Plan of Merger With FNB Bankshares Dated August 25, 2004, incorporated by reference to Exhibit 2.1 to the Company's Form 8-K dated August 25, 2004, filed under item 1.01 on August 27, 2004.

Exhibit 3.1 Conformed Copy of the Registrant's Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed under item 5.03 on October 7, 2004).

Exhibit 3.2 Amendment to the Registrant's Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed under item 5.03 on May 1, 2008).

Exhibit 3.3 Amendment to the Registrant's Articles of Incorporation (incorporated by reference to the Definitive Proxy Statement for the Company's 2008 Annual Meeting filed on March 14, 2008).

Exhibit 3.4 Amendment to the Registrant's Articles of Incorporation authorizing issuance of preferred stock (incorporated by reference to Exhibit 3.1 to Current Report on Form 8-K filed on December 29, 2008).

Exhibit 3.5 Conformed Copy of the Company's Bylaws (incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed under item 5.03 on October 31, 2012).

Exhibit 10.2(a) Specimen Employment Continuity Agreement entered into with Mr. McKim, incorporated by reference to Exhibit 10.2(a) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.2(b) Specimen Amendment to Employment Continuity Agreement entered into with Mr. McKim, incorporated by reference to Exhibit 10.2(b) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.2(c) Specimen Amendment to Employment Continuity Agreement entered into with Mr. McKim, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed under item 1.01 on January 31, 2006.

Exhibit 10.3(a) Specimen Split Dollar Agreement entered into with Mr. McKim with a death benefit of \$250,000. Incorporated by reference to Exhibit 10.3(a) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.3(b) Specimen Amendment to Split Dollar Agreement entered into with Mr. McKim, incorporated by reference to Exhibit 10.3(b) to the Company's Form 8-K filed under item 1.01 on January 14, 2005.

Exhibit 10.4 Specimen Amendment to Supplemental Executive Retirement Plan entered into with Messrs. Daigneault and Ward changing the normal retirement age to receive the full benefit under the Plan from age 65 to age 63, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed under item 1.01 on December 30, 2008.

Exhibit 10.5 Purchase and Assumption Agreement between the Bank and Camden National Bank for the purchase of a bank branch, loans and deposits at 63 Union Street in Rockland, Maine, attached as Exhibit 10.5 to the Company's Quarterly Report on Form 10-Q filed on August 9, 2012.

Exhibit 10.6 Purchase and Sale Agreement between the Bank and Camden National Bank for the purchase of a bank building at 145 Exchange Street in Bangor, Maine, attached as Exhibit 10.6 to the Company's Quarterly Report on Form 10-Q filed on August 9, 2012.

Exhibit 14.1 Code of Ethics for Senior Financial Officers, adopted by the Board of Directors on September 19, 2003. Incorporated by reference to Exhibit 14.1 to the Company's Annual Report on Form 10-K filed on March 15, 2006.

Exhibit 14.2 Code of Business Conduct and Ethics, adopted by the Board of Directors on April 15, 2004. Incorporated by reference to Exhibit 14.2 to the Company's Annual Report on Form 10-K filed on March 15, 2006.

Exhibit 31.1 Certification of Chief Executive Officer Pursuant to Rule 13A-14(A) of The Securities Exchange Act of 1934

Exhibit 31.2 Certification of Chief Financial Officer Pursuant to Rule 13A-14(A) of The Securities Exchange Act of 1934

Exhibit 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002

Exhibit 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002

Exhibit 101.INS XBRL Instance Document

Exhibit 101.SCH XBRL Taxonomy Extension Schema Document

Exhibit 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

Exhibit 101.LAB XBRL Taxonomy Extension Label Linkbase Document

Exhibit 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

Exhibit 101.DEF XBRL Taxonomy Extension Definitions Linkbase

Page 67

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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.

THE FIRST BANCORP, INC.

/s/ Daniel R. Daigneault  
Daniel R. Daigneault  
President & Chief Executive Officer

Date: November 9, 2012

/s/ F. Stephen Ward  
F. Stephen Ward  
Executive Vice President & Chief Financial Officer

Date: November 9, 2012

Page 68