ARROW FINANCIAL CORP
Form 10-Q
November 04, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended September 30, 2008

or

[   ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 0-12507

ARROW FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

New York

22-2448962

(State or other jurisdiction of

(IRS Employer Identification

incorporation or organization)

Number)

250 GLEN STREET, GLENS FALLS, NEW YORK 12801

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (518) 745-1000

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 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.

x 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 x

Non-accelerated filer

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

Yes x No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding as of October 31, 2008
Common Stock, par value $1.00 per share	10,515,826

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ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands) (Unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Cash and Due from Banks	$ 38,325	$ 35,289
Federal Funds Sold	---	16,000
Cash and Cash Equivalents	38,325	51,289
Securities Available-for-Sale	350,526	338,070
Securities Held-to-Maturity (Approximate Fair Value of $130,080 at September 30, 2008 and $114,977 at December 31, 2007)	131,438	114,611
Loans	1,106,506	1,038,844
Allowance for Loan Losses	(12,785)	(12,401)
Net Loans	1,093,721	1,026,443
Premises and Equipment, Net	17,398	16,728
Other Real Estate and Repossessed Assets, Net	331	152
Goodwill	14,726	14,614
Other Intangible Assets, Net	1,731	1,976
Other Assets	24,855	20,963
Total Assets	$1,673,051	$1,584,846
LIABILITIES		
Deposits:		
Demand	$ 190,452	$ 184,273
Regular Savings, N.O.W. & Money Market Deposit Accounts	675,219	590,383
Time Deposits of $100,000 or More	166,124	180,334
Other Time Deposits	240,181	249,210
Total Deposits	1,271,976	1,204,200
Short-Term Borrowings:		
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	69,547	52,630
Other Short-Term Borrowings	1,517	1,089
Federal Home Loan Bank Advances	160,000	160,000
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000

Other Liabilities	24,614	24,671
Total Liabilities	1,547,654	1,462,590
SHAREHOLDERS EQUITY		
Preferred Stock, $5 Par Value; 1,000,000 Shares Authorized	---	---
Common Stock, $1 Par Value; 20,000,000 Shares Authorized		
(14,728,543 Shares Issued at September 30, 2008 and December 31, 2007)	14,729	14,729
Surplus	162,478	161,476
Undivided Profits	23,066	15,347
Unallocated ESOP Shares (122,207 Shares at September 30, 2008		
and 109,885 Shares at December 31, 2007)	(2,572)	(2,042)
Accumulated Other Comprehensive Loss	(6,649)	(4,890)
Treasury Stock, at Cost (4,096,954 Shares at September 30,		
2008 and 3,991,399 Shares at December 31, 2007)	(65,655)	(62,364)
Total Shareholders Equity	125,397	122,256
Total Liabilities and Shareholders Equity	$1,673,051	$1,584,846

See Notes to Unaudited Consolidated Interim Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Per Share Amounts)(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
INTEREST AND DIVIDEND INCOME				
Interest and Fees on Loans	$17,076	$16,675	$50,273	$48,991
Interest on Federal Funds Sold	49	212	463	703
Interest on Bank Balances	4	---	11	---
Interest and Dividends on Securities Available-for-Sale	4,387	3,941	12,802	11,286
Interest on Securities Held-to-Maturity	1,076	1,093	3,240	3,166
Total Interest and Dividend Income	22,592	21,921	66,789	64,146
INTEREST EXPENSE				
Interest on Deposits:				
Time Deposits of $100,000 or More	1,291	2,333	4,395	6,599
Other Deposits	3,995	5,550	13,164	16,342
Interest on Short-Term Borrowings:				
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	221	357	663	1,026
Other Short-Term Borrowings	1	6	8	18
Federal Home Loan Bank Advances	1,890	1,671	5,593	4,831
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	292	355	913	1,054
Total Interest Expense	7,690	10,272	24,736	29,870
NET INTEREST INCOME	14,902	11,649	42,053	34,276
Provision for Loan Losses	253	136	791	322
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	14,649	11,513	41,262	33,954
NONINTEREST INCOME				
Income from Fiduciary Activities	1,349	1,334	4,184	4,206

Fees for Other Services to Customers	2,242	2,097	6,318	6,041
Net Gains (Losses) on Securities Transactions	6	---	(29)	---
Other-Than-Temporary Impairment on Investment Securities	(1,210)	---	(1,210)	---
Gain on Visa Stock Redemption	---	---	749	---
Gain on Sale of Premises	---	---	115	---
Insurance Commissions	528	472	1,575	1,435
Other Operating Income	174	186	415	590
Total Noninterest Income	3,089	4,089	12,117	12,272
NONINTEREST EXPENSE				
Salaries and Employee Benefits	5,883	5,442	17,911	16,198
Occupancy Expense of Premises, Net	841	750	2,616	2,393
Furniture and Equipment Expense	820	720	2,385	2,261
Other Operating Expense	2,988	2,311	8,208	7,305
Total Noninterest Expense	10,532	9,223	31,120	28,157
INCOME BEFORE PROVISION FOR INCOME TAXES	7,206	6,379	22,259	18,069
Provision for Income Taxes	2,198	1,869	6,834	5,218
NET INCOME	$ 5,008	$ 4,510	$15,425	$12,851
Average Shares Outstanding:				
Basic	10,497	10,628	10,578	10,746
Diluted	10,559	10,697	10,635	10,821
Per Common Share:				
Basic Earnings	$ .48	$ .42	$ 1.46	$ 1.20
Diluted Earnings	.47	.42	1.45	1.19

See Notes to Unaudited Consolidated Interim Financial Statements.

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ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(In Thousands, Except Share and Per Share Amounts) (Unaudited)

	Shares Issued	Common Stock	Surplus	Undivided Profits	Unallo- cated ESOP Shares	Accumulated Other Com- prehensive (Loss)	Treasury Stock	Total
Balance at December 31, 2007	14,728,543	$14,729	$161,476	$15,347	$(2,042)	$ (4,890)	$(62,364)	$122,256
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	15,425	---	---	---	15,425
Amortization of Actuarial Loss								
(Pre-tax $332)	---	---	---	---	---	201	---	201
Amortization of Prior Service								
Credit (Pre-tax $158)	---	---	---	---	---	(95)	---	(95)
Net Unrealized Securities Holding								
Losses Arising During the Period,								
Net of Tax (Pre-tax $3,089)	---	---	---	---	---	(1,865)	---	(1,865)
Comprehensive Income								13,666
Cash Dividends Paid,								
$.73 per Share	---	---	---	(7,706)	---	---	---	(7,706)
Stock Options Exercised	---	---	344	---	---	---	434	778

(51,694 Shares)								
Shares Issued Under the Directors Stock Plan (2,753 Shares)	---	---	39	---	---	---	23	62
Shares Issued Under the Employee Stock Purchase Plan (15,129 Shares)	---	---	192	---	---	---	127	319
Stock-Based Compensation Expense	---	---	86	---	---	---	---	86
Tax Benefit for Disposition of Stock Options	---	---	29	---	---	---	---	29
Acquisition by ESOP of Arrow Stock (43,262 Shares)	---	---	---	---	(1,000)	---	---	(1,000)
Allocation of ESOP Stock (30,940 Shares)	---	---	243	---	470	---	---	713
Acquisition of Subsidiary (5,129 Shares)	---	---	69	---	---	---	43	112
Purchase of Treasury Stock (180,260 Shares)	---	---	---	---	---	---	(3,918)	(3,918)
Balance at September 30, 2008	14,728,543	$14,729	$162,478	$23,066	$(2,572)	$(6,649)	$(65,655)	$125,397

See Notes to Unaudited Consolidated Interim Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(In Thousands, Except Share and Per Share Amounts) (Unaudited)

	Shares Issued	Common Stock	Surplus	Undivided Profits	Unallo-cated ESOP Shares	Accumulated Other Com-prehensive (Loss)	Treasury Stock	Total
Balance at December 31, 2006	14,299,556	$14,300	$150,919	$17,619	$ (862)	$ (7,965)	$(55,881)	$118,130
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	12,851	---	---	---	12,851
Amortization of Actuarial Loss								
(Pre-tax $333)	---	---	---	---	---	184	---	184
Amortization of Prior Service								
Credit (Pre-tax $180)	---	---	---	---	---	(110)	---	(110)
Net Unrealized Securities Holding								
Gains Arising During the Period,								
Net of Tax (Pre-tax $2,872)	---	---	---	---	---	1,734	---	1,734
Comprehensive Income								14,659
3% Stock Dividend	428,987	429	9,148	(9,577)	---	---	---	---
Cash Dividends Paid,								
$.70 per Share	---	---	---	(7,483)	---	---	---	(7,483)
Stock Options Exercised	---	---	199	---	---	---	187	386

(24,912 Shares)								
Shares Issued Under the Directors								
Stock Plan (3,293 Shares)	---	---	48	---	---	---	25	73
Shares Issued Under the Employee								
Stock Purchase Plan (16,769								
Shares)	---	---	231	---	---	---	131	362
Stock-Based Compensation								
Expense	---	---	49	---	---	---	---	49
Tax Benefit for Disposition of								
Stock Options	---	---	37	---	---	---	---	37
Acquisition by ESOP of Arrow Stock								
(67,190 Shares)	---	---	---	---	(1,500)	---	---	(1,500)
Allocation of ESOP Stock								
(23,317 Shares)	---	---	202	---	320	---	---	522
Acquisition of Subsidiary								
(4,317 Shares)	---	---	79	---	---	---	32	111
Purchase of Treasury Stock								
(289,150 Shares)	---	---	---	---	---	---	(6,472)	(6,472)
Balance at September 30, 2007	14,728,543	$14,729	$160,912	$13,410	$(2,042)	$(6,157)	$(61,978)	$118,874

Cash dividends declared have been adjusted for the September 2007 3% stock dividend.

Included in the shares issued for the 3% stock dividend in 2007 were treasury shares of 116,690 and unallocated ESOP shares of 3,201.

See Notes to Unaudited Consolidated Interim Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)(Unaudited)

	Nine Months Ended September 30, 2008	2007
Operating Activities:		
Net Income	$15,425	$12,851
Adjustments to Reconcile Net Income to Net Cash		
Provided by Operating Activities:		
Provision for Loan Losses	791	322
Depreciation and Amortization	2,037	2,212
Compensation Expense for Allocated ESOP Shares	243	202
Gains on the Sale of Securities Available-for-Sale	(10)	---
Losses on the Sale of Securities Available-for-Sale	39	---
Other-Than-Temporary Impairment on Investment Securities	1,210	---
Loans Originated and Held-for-Sale	(2,095)	(1,428)
Proceeds from the Sale of Loans Held-for-Sale	3,385	3,665
Net Gains on the Sale of Loans	(56)	(33)
Net (Gains) Losses on the Sale of Fixed Assets,		
Other Real Estate Owned and Repossessed Assets	(111)	13
Contributions to Pension Plans	(2,232)	(2,375)
Deferred Income Tax Expense	426	969
Stock-Based Compensation Expense	86	49
Shares Issued Under the Directors Stock Plan	62	73
Net Increase in Other Assets	(1,472)	(1,988)
Net Increase (Decrease) in Other Liabilities	281	(18)
Net Cash Provided By Operating Activities	18,009	14,514
Investing Activities:		
Proceeds from the Sale of Securities Available-for-Sale	5,518	2,225
Proceeds from the Maturities and Calls of Securities Available-for-Sale	87,125	38,689
Purchases of Securities Available-for-Sale	(109,699)	(58,588)
Proceeds from the Maturities of Securities Held-to-Maturity	19,471	9,046
Purchases of Securities Held-to-Maturity	(36,443)	(16,418)
Net Increase in Loans	(69,843)	(28,513)

Proceeds from the Sales of Premises and Equipment,		
Other Real Estate Owned and Repossessed Assets	843	793
Purchases of Premises and Equipment	(2,038)	(1,746)
Net Cash Used In Investing Activities	(105,066)	(54,512)
Financing Activities:		
Net Increase in Deposits	67,776	31,105
Net Increase in Short-Term Borrowings	17,345	467
Federal Home Loan Bank Advances	---	30,000
Federal Home Loan Bank Repayments	---	(5,000)
Purchases of Treasury Stock	(3,918)	(6,472)
Treasury Stock Issued for Stock-Based Plans	1,097	748
Tax Benefit from Exercise of Stock Options	29	37
Acquisition of Unallocated Common Stock by the ESOP	(1,000)	(1,500)
Allocation of Common Stock Purchased by the ESOP	470	320
Cash Dividends Paid	(7,706)	(7,483)
	(6,663)	(6,663)
Net Cash Provided By Financing Activities	74,093	42,222
Net (Decrease) Increase in Cash and Cash Equivalents	(12,964)	2,224
Cash and Cash Equivalents at Beginning of Period	51,289	43,995
Cash and Cash Equivalents at End of Period	$38,325	$46,219
Supplemental Cash Flow Information:		
Cash Paid During the Period for:		
Interest on Deposits and Borrowings	$26,479	$29,369
Income Taxes	5,945	5,902
Non-cash Investing and Financing Activities:		
Transfer of Loans to Other Real Estate Owned and Repossessed Assets	540	501
Changes in the Valuation Allowance for Securities Available-for-Sale, Net of Tax	1,865	1,734
Shares Issued for CFG Acquisition	112	111
Change in Pension Liability Recognized in Other Comprehensive Income	106	74

See Notes to Unaudited Consolidated Interim Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

September 30, 2008

1. Financial Statement Presentation

In the opinion of the management of Arrow Financial Corporation (Arrow), the accompanying unaudited consolidated interim financial statements contain all of the adjustments necessary to present fairly the financial position as of September 30, 2008 and December 31, 2007; the results of operations for the three-month and nine-month periods ended September 30, 2008 and 2007; the change in shareholders equity for the nine-month periods ended September 30, 2008 and 2007 and the cash flows for the nine-month periods ended September 30, 2008 and 2007. All such adjustments are of a normal recurring nature. The unaudited consolidated interim financial statements should be read in conjunction with the annual consolidated financial statements of Arrow for the year ended December 31, 2007, included in Arrow s 2007 Form 10-K.

2. Accumulated Other Comprehensive Loss (In Thousands)

The following table presents the components, net of tax, of accumulated other comprehensive loss as of September 30, 2008 and December 31, 2007:

	2008	2007
Excess of Additional Pension Liability Over Unrecognized Prior Service Cost	$(4,747)	$(4,853)
Net Unrealized Holding Losses on Securities Available-for-Sale	(1,902)	(37)
Total Accumulated Other Comprehensive Loss	$(6,649)	$(4,890)

3. Earnings Per Common Share (In Thousands, Except Per Share Amounts)

The following table presents a reconciliation of the numerator and denominator used in the calculation of basic and diluted earnings per common share (EPS) for the three-month and nine-month periods ended September 30, 2008 and 2007:

	Income (Numerator)	Shares (Denominator)	Per Share Amount
For the Three Months Ended September 30, 2008:			
Basic EPS	$5,008	10,497	$.48
Dilutive Effect of Stock Options	---	62	
Diluted EPS	$5,008	10,559	$.47
For the Three Months Ended September 30, 2007:			
Basic EPS	$4,510	10,628	$.42
Dilutive Effect of Stock Options	---	69	
Diluted EPS	$4,510	10,697	$.42
For the Nine Months Ended September 30, 2008:			
Basic EPS	$15,425	10,578	$1.46
Dilutive Effect of Stock Options	---	57	
Diluted EPS	$15,425	10,635	$1.45
For the Nine Months Ended September 30, 2007:			
Basic EPS	$12,851	10,746	$1.20
Dilutive Effect of Stock Options	---	75	
Diluted EPS	$12,851	10,821	$1.19

4. Retirement Plans (In Thousands)

The following table provides the components of net periodic benefit costs for the three months ended September 30:

	Pension Benefits		Postretirement Benefits	
	2008	2007	2008	2007
Service Cost	$267	$249	$ 46	$ 41
Interest Cost	436	405	105	95
Expected Return on Plan Assets	(635)	(626)	---	---
Amortization of Prior Service Credit	(24)	(31)	(29)	(30)
Amortization of Net Loss	87	82	24	30
Net Periodic Benefit Cost	$131	$ 79	$146	$136

The following table provides the components of net periodic benefit costs for the nine months ended September 30:

	Pension Benefits		Postretirement Benefits	
	2008	2007	2008	2007
Service Cost	$ 794	$ 746	$133	$124
Interest Cost	1,296	1,216	309	287
Expected Return on Plan Assets	(1,886)	(1,849)	---	---
Amortization of Prior Service Credit	(70)	(91)	(88)	(89)
Amortization of Net Loss	259	244	73	89
Net Periodic Benefit Cost	$ 393	$ 266	$427	$411

During the first nine months of 2008, we made a $2 million contribution to our qualified pension plan. In October 2008, we contributed an additional $3 million. Through September 30, 2008, we contributed $232 to the nonqualified pension plan. We contributed $223 to our postretirement benefit plans for the first nine months of 2008 and expect the total for 2008 to amount to $292.

5. Stock-Based Compensation Plans (Dollars In Thousands)

Under our 1998 Long-Term Incentive Plan, we granted options to purchase 44,500 shares of our common stock in 2007. No stock options have been granted in 2008, to date, under the shareholder approved 2008 Long-Term Incentive Plan, which authorized a maximum of 300,000 shares. The weighted-average fair value of options granted during 2007 was $4.37. The fair value was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: dividend yield 4.34%; expected volatility - 27.3%; risk free interest rate 3.77%; and an expected life of 8.09 years. The fair value of our grants is expensed over the four year vesting period. The expense for the third quarter of 2008 and 2007 was $29 and $16, respectively. The expense for the first nine months of 2008 and 2007 was $86 and $49, respectively.

Arrow also sponsors an Employee Stock Purchase Plan under which employees purchase Arrow s common stock at a 5% discount below market price. Under Statement of Financial Accounting Standards (SFAS) Statement No. 123(R), a stock purchase plan with a discount of 5% or less is not considered a compensatory plan.

5. Stock-Based Compensation Plans, continued

The following table presents the activity in Arrow s stock option plans for the first nine months of 2008 and 2007:

	2008		2007	
		Weighted-Average Exercise		Weighted-Average Exercise
Options:	Shares	Price	Shares	Price
Outstanding at January 1	519,557	$20.77	551,154	$20.01
Granted	---	---	---	---
Exercised	(51,694)	15.06	(25,658)	15.04
Forfeited	(1,450)	25.86	(6,115)	24.74
Outstanding at September 30	466,413	21.39	519,381	20.20
Exercisable at September 30	387,051	21.11	472,939	19.82

6. Guarantees (In Thousands)

We do not issue any guarantees that would require liability-recognition or disclosure, other than standby and other letters of credit. Standby and other letters of credit are conditional commitments that are issued to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including bond financing and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Typically, these instruments have terms of twelve months or less. Since a large percentage of these instruments expire unused, the total amounts do not necessarily represent future cash requirements. Some have automatic renewal provisions.

For letters of credit, the amount of the collateral obtained, if any, is based on management s credit evaluation of the counter-party. We had approximately $15,669 of standby letters of credit outstanding on September 30, 2008, most of which will expire within one year and some of which were not collateralized. At that date, all the letters of credit were for private borrowing arrangements. The fair value of our standby letters of credit at September 30, 2008 was insignificant.

7. Fair Value Disclosures and Fair Value Option (In Thousands)

We adopted Statement of Financial Accounting Standards (SFAS) Statement No. 157,   Fair Value Measurements (SFAS No. 157) on January 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements).

The three levels of the fair value hierarchy under SFAS No. 157 are:

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Level 1   Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

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Level 2   Quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;

.

Level 3   Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

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. SFAS Statement No. 159,   The Fair Value Option for Financial Assets and Financial Liabilities   became effective January 1, 2008 for the Company. We did not elect under SFAS No. 159 to measure any eligible items at fair value under SFAS No. 157 at that date.

7. Fair Value Disclosures and Fair Value Option, continued

The only assets or liabilities that Arrow measured at fair value on a recurring basis at September 30, 2008 were securities available-for-sale. Arrow held no securities or liabilities for trading on such date. The fair value measurement of securities available-for-sale on such date was as follows:

		Fair Value Measurements at Reporting Date Using:		
		Quoted Prices In Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Description	9/30/2008	(Level 1)	(Level 2)	(Level 3)
Securities Available-for Sale	$350,526	$2,162	$347,358	$1,006

Securities available-for-sale are fair valued utilizing independent bond pricing services for identical assets or significantly similar securities. The pricing services use a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows. Based on the inputs used by our independent pricing services, we identify the appropriate level within the fair value hierarchy to report these fair values in accordance with SFAS 157. We do not hold, nor have we ever invested in, any auction rate investment securities.

On October 10, 2008, the FASB issued FASB Staff Position (FSP) 157-3, an amendment of SFAS No. 157, to clarify the application of SFAS No. 157 in an inactive market by providing an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. Application issues addressed by the FSP include: a. How management's internal assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable data do not exist; b. How observable market information in a market that is not active should be considered when measuring fair value; c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable data available to measure fair value. Effective for any unissued financial statements, we have applied the FSP to the valuation of two securities in our securities available-for-sale portfolio as of September 30, 2008: 1) our holding of a Lehman Brothers bond, and 2) our holding of a pooled trust preferred security. These securities are included in Level 3 assets in the table of assets that Arrow measured at fair value on a recurring basis at September 30, 2008, above. We employed the following methods in our analysis of the fair values: a) Lehman bond - since Lehman Brothers declared bankruptcy on September 15, 2008, the market for this bond has been very illiquid. The price provided by our third-party pricing service reflected values from distressed sales that have occurred, which we have determined do not reflect the fair value of this security. We obtained additional value estimates from unobservable inputs including an estimated price range from an independent credit research firm. Since Lehman is in bankruptcy, and the future anticipated cash flows available to bondholders cannot be reasonably estimated, we were unable to perform a discounted cash flow valuation analysis. Thus we determined the fair value of the bond based on the lowest price in the independent credit research firm s range; b) trust preferred security - due to the fact that the last transaction for this thinly traded security was from a distressed sale, the price provided by our third-party pricing service was not determined to reflect the fair value of this security. We obtained additional value estimates from unobservable inputs including an estimated price range from an independent valuation firm and have determined the fair value of the bond based on the lowest price in the independent valuation firm s range.

The following table is a reconciliation of the beginning and ending balances of the Level 3 assets of Arrow, i.e., as to which fair value is measured using significant unobservable inputs, for the third quarter of 2008, all of which are securities available-for-sale:

Beginning Balance, June 30, 2008	$ ---
Transfers In	2,314
Total net losses (realized/unrealized)	
Included in earnings, as a result of other-than-temporary impairment	(1,210)
Included in other comprehensive income	(98)
Ending Balance, September 30, 2008	$1,006
The amount of total losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2008, as a result of other-than-temporary impairment	$(1,210)

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7. Fair Value Disclosures and Fair Value Option, continued

The only asset or liability that Arrow measured at fair value on a nonrecurring basis was other real estate owned:

		Fair Value Measurements Using:			
		Quoted Prices	Significant		
		In Active	Other	Significant	
	Period	Markets for	Observable	Unobservable	Total
	Ended	Identical Assets	Inputs	Inputs	Gains
Description	9/30/2008	(Level 1)	(Level 2)	(Level 3)	(Losses)
Other Real Estate Owned	$123	---	$123	---	---

Other real estate owned, in the table above, consists of one property acquired during the first quarter of 2008. Fair value was obtained from an appraisal by an independent third party appraiser and was based on a comparison to recent sales of similar properties and the fact that we are improving the property, prior to sale. The charge to reduce the property to its fair value, less estimated cost to sell, was recorded as a loan charge-off, prior to the transfer to other real estate owned.

Other impaired assets which might have been included in this table include mortgage servicing rights, goodwill and other intangible assets. Arrow evaluates each of these assets for impairment on a quarterly basis, with no impairment recognized for these assets at September 30, 2008.

8. Visa Inc. IPO, Mandatory Class B Share Redemption and Litigation Liability (Dollars In Thousands)

In December 2007, we recorded a $600 liability for our proportional share, as a member bank of the Visa credit card organization, of certain estimated litigation costs incurred by Visa U.S.A., Inc., as described in our Form 10-K for December 31, 2007. On March 28, 2008, VISA Inc. distributed to member banks , in a mandatory redemption of 38.7% of its Class B shares held by the member banks, some of the proceeds realized by Visa from the initial public offering (IPO) of its Class A shares on March 19, 2008. With another portion of the IPO proceeds, Visa established a $3 billion escrow to cover certain, but not all, potential additional litigation liabilities.

During the first quarter of 2008, we recorded the following transactions:

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A gain of $749 from the mandatory redemption by Visa of 38.7% of our Class B Visa Inc. shares, reflected in noninterest income, and

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A reversal of $306 of the $600 accrual at December 31, 2007 of our estimate of the fair value of our proportionate share of Visa litigation costs, reflected as a reduction in 2008 other operating expense.

Accordingly, we have a remaining liability of $294 included as a component of Other Liabilities in the consolidated balance sheet as of September 30, 2008, representing our estimate of the fair value of potential losses related to the remaining covered Visa litigation. Class B shares which were not redeemed will be converted to Class A shares, at a conversion ratio to be determined based on member banks actual liability for litigation expenses, on the later of three years or the settlement of litigation indemnified by member banks. These remaining Class B shares are available to fund future Visa litigation liabilities indemnified by the member banks until that time. In accordance with Generally Accepted Accounting Principles (GAAP) and consistent with the Securities and Exchange Commission (SEC) guidance, the Company has not recognized any value for its remaining Visa Class B shares.

In October 2008, Visa announced that it had settled the lawsuit with Discover Financial Services, which was part of the covered litigation for which the Visa member banks are contingently liable. As a result, Visa intends to repurchase approximately 12% of the remaining Class B shares held by member banks to fund the settlement of the Discover litigation during the fourth quarter of 2008. The Company did not recognize the value of these shares in accordance with the guidance discussed above, nor did the Company recognize any additional costs for this litigation settlement. The estimation of the Company s proportionate share of any potential losses related to certain covered litigation is extremely difficult and involves a high degree of judgment. Management has determined the remaining $294 liability included in Other Liabilities on its consolidated balance sheet, is the fair value of our proportionate share of the remaining covered Visa litigation as of September 30, 2008, but, this value is subject to change depending upon future litigation developments.

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9. Recently Issued Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued revised Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations." SFAS No. 141(R) retains the fundamental requirements of SFAS No. 141 that the acquisition method of accounting (formerly the purchase method) be used for all business combinations; that an acquirer be identified for each business combination; and that intangible assets be identified and recognized separately from goodwill. SFAS No. 141(R) requires the acquiring entity in a business combination to recognize the assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. Additionally, SFAS No. 141(R) changes the requirements for recognizing assets acquired and liabilities assumed arising from contingencies and recognizing and measuring contingent consideration. SFAS No. 141(R) also enhances the disclosure requirements for business combinations. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 and may not be applied before that date. The impact that SFAS No. 141 is expected to have on our financial condition or results of operations is indeterminable as it is prospective in nature.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51," (SFAS No. 160). SFAS No. 160 amends Accounting Research Bulletin No. 51, "Consolidated Financial Statements" to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Among other things, SFAS No. 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. SFAS No. 160 also amends SFAS No. 128, "Earnings per Share," so that earnings per share calculations in consolidated financial statements will continue to be based on amounts attributable to the parent. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 and is applied prospectively as of the beginning of the fiscal year in which it is initially applied, except for the presentation and disclosure requirements which are to be applied retrospectively for all periods presented. SFAS No. 160 is not expected to have a material impact on our financial condition or results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, (SFAS No. 161). The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance, and cash flows. The new standard also improves transparency about the location and amounts of derivative instruments in an entity s financial statements; how derivative instruments and related hedged items are accounted for under Statement 133, Accounting for Derivative Instruments and Hedging Activities ; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. SFAS No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity s liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. SFAS No. 161 is not expected to have a material impact on our financial condition or results of operations.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Arrow Financial Corporation:

We have reviewed the consolidated balance sheet of Arrow Financial Corporation and subsidiaries (the Company) as of September 30, 2008, and the related consolidated statements of income for the three-month and nine-month periods ended September 30, 2008 and 2007, and the consolidated statements of changes in shareholders equity and cash flows for the nine-month periods ended September 30, 2008 and 2007. These consolidated financial statements are the responsibility of the Company s management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of 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 consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Arrow Financial Corporation and subsidiaries as of December 31, 2007, and the related consolidated statements of income, changes in shareholders equity and cash flows for the year then ended (not presented herein); and in our report dated March 6, 2008, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2007, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Albany, New York

November 3, 2008

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Item 2.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SEPTEMBER 30, 2008

Note on Terminology - In this Quarterly Report on Form 10-Q, the terms Arrow, the registrant, the company, we, and our generally refer to Arrow Financial Corporation and its subsidiaries as a group, except where the context indicates otherwise. Arrow is a two-bank holding company headquartered in Glens Falls, New York. Our banking subsidiaries are Glens Falls National Bank and Trust Company (Glens Falls National) whose main office is located in Glens Falls, New York, and Saratoga National Bank and Trust Company (Saratoga National) whose main office is located in Saratoga Springs, New York. Our non-bank subsidiaries include Capital Financial Group, Inc. (an insurance agency specializing in selling and servicing group health care policies), North Country Investment Advisers, Inc. (a registered investment adviser that provides investment advice to our proprietary mutual funds), Arrow Properties, Inc. (a real estate investment trust, or REIT) and U.S. Benefits, Inc. (a provider of administrative and recordkeeping services for more complex retirement plans), all of which are subsidiaries of Glens Falls National.

At certain points in this Report, our performance is compared with that of our peer group of financial institutions. Unless otherwise specifically stated, this peer group is comprised of the group of 278 domestic bank holding companies with $1 to $3 billion in total consolidated assets as identified in the Federal Reserve Board s Bank Holding Company Performance Report for June 2008 (the most recent such Report currently available), and peer group data has been derived from such Report.

Forward Looking Statements - The information contained in this Quarterly Report on Form 10-Q contains statements that are not historical in nature but rather are based on our beliefs, assumptions, expectations, estimates and projections about the future. These statements are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and involve a degree of uncertainty and attendant risk. Words such as expects, believes, anticipates, estimates and variations of such words and similar expressions are intende identify such forward-looking statements. Some of these statements, such as those included in the interest rate sensitivity analysis in Item 3, entitled Quantitative and Qualitative Disclosures About Market Risk, are merely presentations of what future performance or changes in future performance would look like based on hypothetical assumptions and on simulation models. Other forward-looking statements are based on our general perceptions of market conditions and trends in business activity, both our own and in the banking industry generally, as well as current management strategies for future operations and development.

Certain forward-looking statements in this Report are referenced in the table below:

Topic	Page	Location
Impact of market rate structure on net interest margin,		
loan yields and deposit rates	23	4th paragraph
	25	1st, 3rd and 4th paragraphs
	27	Last paragraph
	41	Last paragraph
Change in the level of loan losses and nonperforming loans and assets	29	1st paragraph under Provision for Loan Losses
	30	1st paragraph
	31	4th paragraph
Estimated provision and allowance for loan losses	29	Last paragraph
Future level of residential real estate loans	27	1st paragraph
Impact of competition for indirect loans	27	3rd paragraph
Liquidity	21	Last bullet under Financial Market Turmoil
	33	Last paragraph
Intent to acquire Upstate Agency, Inc.	22	7th paragraph

These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to quantify or, in some cases, to identify. In the case of all forward-looking statements, actual outcomes and results may differ materially from what the statements predict or forecast. Factors that could cause or contribute to such differences include, but are not limited to, rapid and dramatic changes in economic and market conditions, such as the U.S. economy is currently experiencing, including sharp fluctuations in interest rates, economic activity, and consumer spending patterns; sudden changes in the market for products we provide, such as real estate loans; new developments in state and federal regulation; enhanced competition from unforeseen sources; new emerging technologies; unexpected loss of key personnel; unanticipated business opportunities; and similar uncertainties inherent in banking operations or business generally. In the current environment of substantial economic turmoil affecting all sectors of business in the U.S., including the financial sector, all forward-looking statements should be understood as embracing a substantial degree of uncertainty far exceeding that accompanying such statements under normal economic conditions.

Readers are cautioned not to place undue reliance on any forward-looking statements in this Report, which speak only as of the date hereof. We undertake no obligation to revise or update these forward-looking statements to reflect future occurrences, including unanticipated events. This Quarterly Report should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2007.

USE OF NON-GAAP FINANCIAL MEASURES

The Securities and Exchange Commission (SEC) has adopted Regulation G, which applies to all public disclosures, including earnings releases, made by registered companies that contain non-GAAP financial measures. GAAP is generally accepted accounting principles in the United States of America. Under Regulation G, companies making public disclosures containing non-GAAP financial measures must also disclose, along with each non-GAAP financial measure, certain additional information, including a reconciliation of the non-GAAP financial measure to the closest comparable GAAP financial measure and a statement of the Company s reasons for utilizing the non-GAAP financial measure as part of its financial disclosures. As a parallel measure with Regulation G, the SEC stipulated in Item 10 of its Regulation S-K that public companies must make the same types of supplemental disclosures whenever they include non-GAAP financial measures in their filings with the SEC. The SEC has exempted from the definition of non-GAAP financial measures certain commonly used financial measures that are not based on GAAP. When these exempted measures are included in public disclosures or SEC filings, supplemental information is not required. The following measures used in this Report, which although commonly utilized by financial institutions have not been specifically exempted by the SEC, may constitute "non-GAAP financial measures" within the meaning of the SEC's new rules, although we are unable to state with certainty that the SEC would so regard them.

Tax-Equivalent Net Interest Income and Net Interest Margin: Net interest income, as a component of the tabular presentation by financial institutions of Selected Financial Information regarding their recently completed operations, is commonly presented on a tax-equivalent basis. That is, to the extent that some component of the institution's net interest income which is presented on a before-tax basis, is exempt from taxation (e.g., is received by the institution as a result of its holdings of state or municipal obligations), an amount equal to the tax benefit derived from that component is added back to the net interest income total. This adjustment is considered helpful in comparing one financial institution's net interest income to that of another institution, to correct any distortion that might otherwise arise from the fact that the two institutions typically will have different proportions of tax-exempt items in their portfolios. Moreover, net interest income is itself 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, tax-equivalent net interest income is generally used by financial institutions, again to provide a better basis of comparison from institution to institution. We follow these practices.

The Efficiency Ratio: Financial institutions often use an "efficiency ratio" as a measure of expense control. The efficiency ratio typically is defined as the ratio of noninterest expense to net interest income and noninterest income. Net interest income as utilized in calculating the efficiency ratio is typically expressed on a tax-equivalent basis. Moreover, most financial institutions, in calculating the efficiency ratio, also adjust both noninterest expense and noninterest income to exclude from these items (as calculated under GAAP) certain component elements, such as intangible asset amortization (deducted from noninterest expense) and securities gains or losses (excluded from noninterest income). We follow these practices.

Tangible Book Value per Share: Tangible equity is total shareholders equity less intangible assets. Tangible book value per share is tangible equity divided by total shares issued and outstanding. Tangible book value per share is often regarded as a more meaningful comparative ratio than book value per share as calculated under GAAP, that is, total shareholders equity including intangible assets divided by total shares issued and outstanding. Intangible assets as a category of assets includes many items, such as goodwill.

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Selected Quarterly Information:

(Dollars In Thousands, Except Per Share Amounts)

	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Net Income	$5,008	$5,436	$4,981	$4,481	$4,510
Transactions Recorded in Net Income (Net of Tax):					
Visa Litigation[1]	$ ---	$ ---	$185	$(362)	$---
Gain on Redemption of Visa Inc. Class B Shares[1]	---	---	452	---	---
Other-Than-Temporary Impairment (OTTI)	(731)	---	---	---	---
Net Securities Gains (Losses)	4	(21)	---	---	---
Net Gain on the Sale of Premises	---	---	69	---	---
Net Gain on Sales of Loans	8	19	5	5	2
Net Loss on the Sale of Other Real Estate Owned	---	---	---	(5)	---
Period End Shares Outstanding	10,509	10,516	10,637	10,627	10,612
Basic Average Shares Outstanding	10,497	10,593	10,645	10,619	10,628
Diluted Average Shares Outstanding	10,559	10,650	10,694	10,682	10,697
Basic Earnings Per Share	.48	.51	$.47	$.42	$.42
Diluted Earnings Per Share	.47	.51	.47	.42	.42
Cash Dividends Per Share	.25	.24	.24	.24	.23
Stock Dividends/Splits	---	---	---	---	3%
Average Assets	$1,657,666	$1,625,093	$1,606,082	$1,601,053	$1,566,329
Average Equity	124,601	126,177	124,686	120,433	116,362
Return on Average Assets	1.20%	1.35%	1.25%	1.11%	1.14%
Return on Average Equity	15.99	17.33	16.07	14.76	15.38
Average Earning Assets	$1,580,408	$1,548,365	$1,530,061	$1,526,148	$1,494,744
Average Paying Liabilities	1,308,191	1,288,047	1,272,871	1,265,765	1,231,812
Interest Income, Tax-Equivalent [1]	23,302	22,861	22,832	23,171	22,669
Interest Expense	7,690	7,751	9,295	10,413	10,272
Net Interest Income, Tax-Equivalent [1]	15,612	15,110	13,537	12,758	12,397
Tax-Equivalent Adjustment	710	746	750	740	748
Net Interest Margin [1]	3.93%	3.92%	3.56%	3.32%	3.29%

Efficiency Ratio Calculation:[1]					
Noninterest Expense	$10,532	$10,409	$10,179	$ 9,773	$ 9,223
Less: Intangible Asset Amortization	(89)	(86)	(96)	(96)	(96)
Net Noninterest Expense	10,443	$10,323	$10,083	$ 9,677	$ 9,127
Net Interest Income, Tax-Equivalent [1]	15,612	$15,110	$13,537	$12,758	$12,397
Noninterest Income	3,089	4,181	4,847	4,016	4,089
Less: Net Securities Losses & OTTI (Gains)	1,204	35	(749)	---	---
Net Gross Income	19,905	$19,326	$17,635	$16,774	$16,486
Efficiency Ratio [1]	52.46%	53.42%	57.18%	57.69%	55.36%
Period-End Capital Information:					
Tier 1 Leverage Ratio	8.32%	8.45%	8.54%	8.37%	8.39%
Total Shareholders Equity (i.e. Book Value)	$125,397	$124,080	$127,051	$122,256	$118,874
Book Value per Share	11.93	11.80	11.94	11.50	11.20
Intangible Assets	16,457	16,495	16,593	16,590	16,699
Tangible Book Value per Share[1]	10.36	10.23	10.38	9.94	9.63
Asset Quality Information:					
Net Loans Charged-off as a Percentage of Average Loans, Annualized	.07%	.00%	.08%	.05%	.04%
Provision for Loan Losses as a Percentage of Average Loans, Annualized	.09	.09	.11	.07	.05
Allowance for Loan Losses as a Percentage of Loans, Period-end	1.16	1.20	1.20	1.19	1.19
Allowance for Loan Losses as a Percentage of Nonperforming Loans, Period-end	444.08	502.17	407.05	567.81	610.64
Nonperforming Loans as a Percentage of Loans, Period-end	.26	.24	.29	.21	.20
Nonperforming Assets as a Percentage of Total Assets, Period-end	.24	.17	.20	.15	.13

[1] See Use of Non-GAAP Financial Measures on page 16.

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Selected Nine-Month Period Information:

(Dollars In Thousands, Except Per Share Amounts)

	Sep 2008	Sep 2007
Net Income	$15,425	$12,851
Transactions Recorded in Net Income (Net of Tax):		
Visa Litigation[1]	$ 185	$---
Gain on Redemption of Visa Inc. Class B Shares[1]	452	---
Other-Than-Temporary Impairment (OTTI)	(731)	---
Net Securities Losses	(17)	---
Net Gain on the Sale of Premises	69	---
Net Gain on Sales of Loans	32	19
Net Gain on the Sale of Other Real Estate Owned	---	3
Period End Shares Outstanding	10,509	10,612
Basic Average Shares Outstanding	10,578	10,746
Diluted Average Shares Outstanding	10,635	10,821
Basic Earnings Per Share	1.46	1.20
Diluted Earnings Per Share	1.45	1.19
Cash Dividends	.73	.70
Average Assets	$1,629,719	$1,543,826
Average Equity	125,155	117,289
Return on Average Assets	1.26%	1.11%
Return on Average Equity	16.46	14.65
Average Earning Assets	$1,553,046	$1,473,415
Average Paying Liabilities	1,289,771	1,217,789
Interest Income, Tax-Equivalent [1]	68,995	66,325
Interest Expense	24,736	29,870
Net Interest Income, Tax-Equivalent [1]	44,259	36,455
Tax-Equivalent Adjustment	2,206	2,179
Net Interest Margin [1]	3.81%	3.31%

Efficiency Ratio Calculation [1]		
Noninterest Expense	$31,120	$28,157
Less: Intangible Asset Amortization	(271)	(299)
Net Noninterest Expense [1]	30,849	27,858
Net Interest Income, Tax-Equivalent	44,259	36,455
Noninterest Income	12,117	12,272
Less Net Securities Losses & OTTI	490	---
Net Gross Income, Adjusted [1]	56,866	48,727
Efficiency Ratio [1]	54.25%	57.17%
Period-End Capital Information:		
Tier 1 Leverage Ratio	8.32%	8.39%
Total Shareholders Equity (i.e. Book Value)	$125,397	$118,874
Book Value per Share	11.93	11.20
Intangible Assets	16,457	16,699
Tangible Book Value per Share	10.36	9.63
Net Loans Charged-off as a Percentage of Average Loans, Annualized	.05%	.03%
Provision for Loan Losses as a Percentage of Average Loans, Annualized	.10	.04
Allowance for Loan Losses as a Percentage of Period-end Loans	1.16	1.19
Allowance for Loan Losses as a Percentage of Nonperforming Loans	444.08	610.64
Nonperforming Loans as a Percentage of Period-end Loans	.26	.20
Nonperforming Assets as a Percentage of Period-end Total Assets	.24	.13

[1] See Use of Non-GAAP Financial Measures on page 16

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Average Consolidated Balance Sheets and Net Interest Income Analysis

(see Use of Non-GAAP Financial Measures on page 16)

(Tax-equivalent Basis using a marginal tax rate of 35%)

(Dollars In Thousands)

Quarter Ended September 30,	2008			2007		
	Average Balance	Interest Income/ Expense	Rate Earned/ Paid	Average Balance	Interest Income/ Expense	Rate Earned/ Paid
Federal Funds Sold	$ 10,158	$ 49	1.92%	$ 16,013	$ 211	5.23%
Bank Balances at Interest	929	4	1.71	---	---	---
Securities Available-for-Sale:						
Taxable	345,281	4,224	4.87	317,111	3,682	4.611
Non-Taxable	18,608	249	5.32	25,848	387	5.94
Securities Held-to-Maturity:						
Taxable	272	3	4.39	308	4	5.15
Non-Taxable	121,869	1,622	5.29	114,065	1,630	5.67
Loans	1,083,291	17,151	6.30	1,021,399	16,755	6.51
Total Earning Assets	1,580,408	23,302	5.87	1,494,744	22,669	6.02
Allowance For Loan Losses	(12,732)			(12,325)		
Cash and Due From Banks	35,673			33,854		
Other Assets	54,317			50,056		
Total Assets	$1,657,666			$1,566,329		
Deposits:						
Interest-Bearing NOW Deposits	$ 353,171	1,167	1.31	$ 310,219	1,687	2.16
Regular and Money Market Savings	288,307	863	1.19	263,620	1,006	1.51
Time Deposits of $100,000 or More	178,041	1,291	2.88	189,685	2,333	4.88
Other Time Deposits	242,069	1,965	3.23	257,056	2,857	4.41
Total Interest-Bearing Deposits	1,061,588	5,286	1.98	1,020,580	7,883	3.06

Short-Term Borrowings	63,198	222	1.40	49,976	363	2.88
Long-Term Debt	183,405	2,182	4.73	161,256	2,026	4.98
Total Interest-Bearing Liabilities	1,308,191	7,690	2.34	1,231,812	10,272	3.31
Demand Deposits	200,193			194,628		
Other Liabilities	24,681			23,527		
Total Liabilities	1,533,065			1,449,967		
Shareholders Equity	124,601			116,362		
Total Liabilities and Shareholders Equity	$1,657,666			$1,566,329		
Net Interest Income (Tax-equivalent Basis)		15,612			12,397	
Net Interest Spread			3.53			2.71
Net Interest Margin			3.93			3.29
Reversal of Tax-Equivalent Adjustment		(710)	(.18)		(748)	(.20)
Net Interest Income, As Reported		$14,902			$11,649	

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Average Consolidated Balance Sheets and Net Interest Income Analysis

(see Use of Non-GAAP Financial Measures on page 16)

(Tax-equivalent Basis using a marginal tax rate of 35%)

(Dollars In Thousands)

Nine Months Ended September 30,	2008			2007		
	Average Balance	Interest Income/ Expense	Rate Earned/ Paid	Average Balance	Interest Income/ Expense	Rate Earned/ Paid
Federal Funds Sold	$ 23,186	$ 463	2.67%	$ 17,900	$ 703	5.25%
Bank Balances at Interest	672	11	2.19	---	---	---
Securities Available-for-Sale:						
Taxable	331,027	12,151	4.90	305,722	10,566	4.62
Non-Taxable	23,153	993	5.73	23,801	1,085	6.09
Securities Held-to-Maturity:						
Taxable	279	10	4.79	314	12	5.11
Non-Taxable	116,303	4,867	5.59	110,149	4,724	5.73
Loans	1,058,426	50,500	6.37	1,015,529	49,235	6.48
Total Earning Assets	1,553,046	68,995	5.93	1,473,415	66,325	6.02
Allowance For Loan Losses	(12,571)			(12,313)		
Cash and Due From Banks	33,967			32,746		
Other Assets	55,277			49,978		
Total Assets	$1,629,719			$1,543,826		
Deposits:						
Interest-Bearing NOW Deposits	$ 354,305	3,865	1.46	$ 302,794	4,778	2.11
Regular and Money Market Savings	279,603	2,667	1.27	266,756	2,959	1.48
Time Deposits of $100,000 or More	174,181	4,395	3.37	182,524	6,599	4.83
Other Time Deposits	242,942	6,632	3.65	260,665	8,605	4.41
Total Interest-Bearing Deposits	1,051,031	17,559	2.23	1,012,739	22,941	3.03

Short-Term Borrowings	56,949	671	1.57	48,515	1,044	2.88
Long-Term Debt	181,791	6,506	4.78	156,535	5,885	5.03
Total Interest-Bearing Liabilities	1,289,771	24,736	2.56	1,217,789	29,870	3.28
Demand Deposits	190,456			185,285		
Other Liabilities	24,337			23,463		
Total Liabilities	1,504,564			1,426,537		
Shareholders Equity	125,155			117,289		
Total Liabilities and Shareholders Equity	$1,629,719			$1,543,826		
Net Interest Income (Tax-equivalent Basis)		44,259			36,455	
Net Interest Spread			3.37			2.74
Net Interest Margin			3.81			3.31
Reversal of Tax-Equivalent Adjustment		(2,206)	(.19)		(2,179)	(.20)
Net Interest Income, As Reported		$42,053			$34,276	

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Financial Market Turmoil: (the following discussion provides the information required under Part II, Item 1.A Risk Factors.) Over the past twelve months, the Dow Jones Industrial Average (Dow Jones) slid from a high of over 14,000 to a low of under 8,000, with the most dramatic change occurring during October 2008, after the close of the third quarter of 2008. The financial markets and particularly financial entities have felt the impact of losses on subprime mortgages and loss of short-term liquidity, including the September 2008 failure of Lehman Brothers Holdings (Lehman) and the distressed sales of Bear Stearns and Merrill Lynch. In addition, the number of bank failures, while not at historic highs, have risen to levels not seen for several years. Many community banks that were not underwriting subprime residential real estate loans, like our company, have not experienced the significant losses in their loan or investment portfolios or the liquidity concerns that our larger contemporaries have experienced. However, the magnitude of turmoil in the markets does or may have an impact on our operations in the following areas:

:

Investment Securities: We do not hold mortgage-backed securities backed by subprime mortgages in our investment portfolio or collateralized debt obligations backed directly or indirectly by such mortgage-backed securities or other low-quality loans. However, we do hold certain corporate bonds and other debt instruments issued by entities whose values have been impacted by the deterioration of the financial markets. The Company holds a $2.0 million senior unsecured bond issued by Lehman. On September 15, 2008, Lehman declared bankruptcy resulting in a significant decline in the market value of the Lehman bond. Management has deemed the decline to be other-than-temporary and, accordingly, recognized a non-cash other-than-temporary impairment charge to third quarter earnings of $731 thousand net of tax (a $.07 reduction in diluted earnings per share). The remaining estimated value of our Lehman bond of $800 thousand has been included in non-performing assets as of September 30, 2008. The Lehman bankruptcy proceedings are ongoing and ultimate value of our bond is subject to further change. Corporate bonds and other debt securities represented only $7.3 million, or 1.5%, of our $482.0 million investment securities portfolio at September 30, 2008. We did not hold any preferred or common stock of Fannie Mae or Freddie Mac.

:

Income from Fiduciary Activities: Our fees in this area generally bear a direct relationship to the fair value of the assets under management. The market value of assets under trust administration and investment management at September 30, 2008, amounted to $862.6 million, a decrease of $98.6 million, or 10.3%, from December 31, 2007.

:

Loans: Credit Quality: We have not engaged in the origination of subprime mortgage loans or in subprime lending as a business line. We have not engaged in real estate development lending except in accordance with our historically rigorous underwriting standards involving substantial collateral protection. To date, we have not experienced any significant deterioration in our credit quality, including in our three major loan portfolio segments:

o

Commercial Loans: We lend to small and medium size businesses, which typically do not encounter liquidity problems, since we provide support for their supplementary liquidity needs. However, current unemployment rates are higher than in the past few years and the number of total jobs has decreased, although these trends are largely attributable to a few changes in the local operations of larger corporations.

o

Residential Real Estate Loans: We have not experienced an increase in our foreclosure rates, primarily due to the fact that we did not originate or participate in underwriting subprime loans.

o

Indirect Automobile Loans: These loans comprise over 30% of our loan portfolio. We have not experienced any significant change in our delinquency rate or level of charge-offs.

:

Liquidity: We have not experienced any liquidity issues (see our general liquidity discussion on page 33). In general, we rely on asset-based liquidity (i.e. cash flow from maturing investments and loans) with liability-based liquidity as a secondary source (overnight lending arrangements with our correspondent banks, FHLB overnight and term advances and the Federal Reserve Bank discount window, as primary sources). During the recent period of bank failures, some institutions experienced a run on deposits, even though there was no reasonable expectation that depositors would lose any of their insured deposits. We maintain, and periodically test, a contingent liquidity plan whose purpose is to ensure that we can generate an adequate amount of cash to meet a wide variety of potential liquidity crises.

OVERVIEW

We reported earnings of $5.008 million for the third quarter of 2008, an increase of $498 thousand, or 11.0%, as compared to $4.510 million for the third quarter of 2007. Diluted earnings per share were $.47 and $.42 for the respective quarters. Average diluted shares outstanding decreased by 1.3% from the third quarter of 2007 to the third quarter of 2008, as repurchases of shares under our common stock repurchase program exceeded the issuance of shares under our compensatory stock plans. For the first nine months of 2008 we reported earnings of $15.425 million, an increase of $2.574 million, or 20.0%, as compared to $12.851 million for the first nine months of 2007. Diluted earnings per share were $1.45 and $1.19 for the respective 2008 and 2007 nine-month periods. Accompanying growth in our net earnings and earnings per share for the quarter and for the nine-month period was an increase in our earning assets, total assets and equity. These patterns are reflected in the return on average assets and the return on average equity.

The return on average assets for the third quarter of 2008 was 1.20%, compared to 1.14% for the third quarter of 2007, an increase of 6 basis points, or 5.3%. The return on average equity for the third quarter of 2008 was 15.99%, compared to 15.38% for the third quarter of 2007, an increase of 61 basis points, or 4.0%. For the first nine months of 2008 and 2007, the return on average assets was 1.26% and 1.11%, respectively. The return on average equity for the first nine months of 2008 was 16.46%, compared to 14.65% for the prior year period, an increase of 181 basis points, or 12.4%.

We achieved these improvements primarily from a strong increase in net interest income, which increased $3.2 million, or 27.9%, from the third quarter of 2007 to the third quarter of 2008. This increase in turn was largely the result of an improving net interest margin, as our cost of funds decreased sharply, more so than our average yield on interest earning assets. The third quarter 2008 net interest income increase was offset, in part, by the recognition of other-than-temporary impairment on the Lehman bond, discussed above.

Despite the significant troubles affecting the U.S. economy generally, our asset quality remained strong at period-end and our net charge-offs for the quarter and year-to-date remain near historic low levels, at an annualized rate of .07% of average loans for the quarter and .05% of average loans for the nine-month period.

Total assets were $1.67 billion at September 30, 2008, an increase of $88.2 million, or 5.6%, from December 31, 2007, and an increase of $96.0 million, or 6.1%, above the level at September 30, 2007.

Total shareholders equity was $125.4 million at September 30, 2008, an increase of $3.1 million, or 2.6%, from December 31, 2007. The increase in total shareholders equity was primarily attributable to an increase in retained earnings, offset in part by repurchases of our common stock, our guarantee of a loan to our Employee Stock Ownership Plan (ESOP) (which requires a reduction to shareholders equity for the shares that have not been allocated to employees) and an increase in the unrealized holding losses, net of tax, on securities in the available-for-sale portfolio. Our risk-based capital ratios and Tier 1 leverage ratio continued to significantly exceed regulatory minimum requirements at period-end. At September 30, 2008 both our banks qualified as "well-capitalized" as defined under regulatory capital guidelines.

On October 14, 2008 we announced that our subsidiary, Glens Falls National Bank and Trust Company, had executed a letter of intent to acquire Upstate Agency, Inc., an independent property and casualty insurance agency headquartered in Chestertown, New York with five offices located in Northeastern New York. The acquisition is subject to the parties entering into a definitive purchase agreement, obtaining all required regulatory approvals and other terms and conditions. We anticipate the transaction will be completed in the fourth quarter of 2008.

As of the date of this Report, we had not determined whether or not we would submit an application to the U.S. Treasury Department and our principal federal bank regulator for an investment of capital by the Treasury Department in our preferred stock under the federal government s recently announced Capital Purchase Program, authorized under the Emergency Economic Stabilization Act of 2008.

CHANGE IN FINANCIAL CONDITION

Summary of Selected Consolidated Balance Sheet Data

(Dollars in Thousands)

Selected Balance Sheet Data:	At Period-End Sep 2008	Dec 2007	Sep 2007	$ Change From Dec	$ Change From Sep	% Change From Dec	% Change From Sep
Federal Funds Sold	$ ---	$ 16,000	$ 4,000	$(16,000)	$(4,000)	(100.0)%	(100.0)%
Securities Available-for-Sale	350,526	338,070	336,055	12,456	14,471	3.7	4.3
Securities Held-to-Maturity	131,438	114,611	115,702	16,827	15,736	14.7	13.6
Loans (1)	1,106,506	1,038,844	1,034,548	67,662	71,958	6.5	7.0
Allowance for Loan Losses	12,785	12,401	12,341	384	444	3.1	3.6
Earning Assets (1)	1,588,470	1,507,525	1,490,305	80,945	98,165	5.4	6.6
Total Assets	1,673,051	1,584,846	1,577,049	88,205	96,002	5.6	6.1
Demand Deposits	$ 190,452	$ 184,273	$ 191,125	$ 6,179	$ (673)	3.4	(0.4)
NOW, Regular Savings & Money							
Market Deposit Accounts	675,219	590,383	607,180	84,836	68,039	14.4	11.2
Time Deposits of $100,000 or More	166,124	180,334	166,916	(14,210)	(792)	(7.9)	(0.5)
Other Time Deposits	240,181	249,210	252,281	(9,029)	(12,100)	(3.6)	(4.8)
Total Deposits	$1,271,976	$1,204,200	$1,217,502	$ 67,776	$54,474	5.6	4.5
Short-Term Borrowings	$ 71,064	53,719	$ 48,791	$ 17,345	$22,273	32.3	45.6
Federal Home Loan Bank Advances:							
Term Advances	160,000	160,000	150,000	---	10,000	---	6.7
Shareholders' Equity	125,397	122,256	118,874	3,141	6,523	2.6	5.5

(1) Includes Nonaccrual Loans

Deposit Generally; Municipal Deposits: We did not experience in the just completed quarter, nor have we experienced since the end of such quarter, unusual developments or changes in the aggregate levels of our deposits, including significant increases in withdrawals, or significant changes in the mix or pricing of our deposits. We have continued the long-term trend of modestly decreasing the rates we pay on deposits, which we initiated in the third quarter of 2007 following the Federal Reserve Board s commencement of a concerted effort to lower short-term interest rates.

As discussed under Changes in Sources of Funds, below, our increase in overall deposit balances in the first nine months of 2008 was largely due to an increase in our municipal deposits over this period. In addition, recent fluctuations in balances of our NOW accounts and time deposits of $100,000 or more are largely the result of municipal deposit fluctuations. Municipal deposits on average have represented 15% to 20% of our total deposits, mainly in NOW accounts and time deposits of short duration. Many of our contractual municipal deposit relationships are subject to annual renewal, by formal or informal agreements.

In general, there is a seasonal pattern to municipal deposits starting with a low point during July and August. Account balances tend to increase throughout the fall and into the winter months from tax deposits and receive an additional boost at the end of March from the electronic deposit of state aid to school districts. In addition to these seasonal fluctuations within accounts, the overall level of municipal deposit balances fluctuates from year-to-year as some municipalities move their accounts in and out of our banks due to competitive factors. Often, the balances of municipal deposits at the end of a quarter are not representative of the average balances for that quarter.

Yield Curve: The shape of the yield curve (i.e. the line depicting interest rates being paid on low- or no-risk securities, such as U.S. Treasury bills, of different maturities, with the rate on the vertical axis and maturity on the horizontal axis) typically turns upward. Our net interest income often reflects our investment of some portion of our short-term, lower-rate deposits in longer-term higher yielding loans and investments and hence our earnings level is affected by the shape of the yield curve; the stronger the upward slope of the yield curve, the more positive the impact on our earnings. During much of 2006 and 2007, the yield curve flattened and at times became inverted, that is, the rates for long-term bonds like U.S. Treasury notes were often less than the rates banks paid for overnight federal funds. During that period our net interest margin compressed and our net interest income declined as a consequence. During the recent sharp decline in short-term interest rates in the fourth quarter of 2007 and the first quarter of 2008, the yield curve returned to its traditional upward slope as longer-term rates tended to resist any comparable downward movement. This upward slope continued throughout the third quarter of 2008. We expect continuing downward pressure on short-term interest rates (and in our deposit rates), but if the Federal Reserve Board s upcoming actions reignite inflationary concerns, this may change.

Changes in Sources of Funds: We experienced an increase in internally generated deposit balances of $67.8 million, or 5.6%, from December 31, 2007 to September 30, 2008. This increase was primarily attributable to a $67.7 million increase in period-end municipal balances. Short-term borrowings increased by $17.3 million (primarily repurchase agreements) and FHLB advances remained unchanged.

Changes in Earning Assets: Our loan portfolio increased by $67.7 million, or 6.5%, from December 31, 2007 to September 30, 2008. We experienced the following trends in our three largest segments:

1.

Residential real estate loans an increase of $18.9 million from December 31, 2007 to September 30, 2008, as originations of approximately $48 million exceeded prepayments and normal amortization.

2.

Indirect loans a $14.8 million, or 4.4%, increase in the level of indirect loans during the first nine months of 2008, reflecting an increased level of activity in the third quarter of 2008 that overcame an 8.7% decrease in the level of originations for the first six months of 2008 compared to the first six months of 2007. During 2008, originations of approximately $130 million were offset by approximately $116 million of prepayments and normal amortization.

3.

Commercial and commercial real estate loans period-end balances for this segment increased by $38.3 million in the first nine months of 2008, reflecting continued moderate to strong demand for commercial lending.

During the nine month period, funds from maturing assets not committed to loan originations were primarily placed in securities available-for-sale (up $12.5 million, or 3.7%, from year-end).

Deposit Trends

The following two tables provide information on trends in the balance and mix of our deposit portfolio by presenting, for each of the last five quarters, the quarterly average balances by deposit type and the percentage of total deposits represented by each deposit type.

Quarterly Average Deposit Balances

(Dollars in Thousands)

	Quarter Ended				
	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Demand Deposits	$ 200,193	$ 188,949	$ 182,118	$ 190,002	$ 194,628
Interest-Bearing Demand Deposits	353,171	370,458	339,296	353,655	310,219
Regular and Money Market Savings	288,307	284,695	265,712	263,784	263,620
Time Deposits of $100,000 or More	178,041	156,850	187,610	174,915	189,685
Other Time Deposits	242,069	238,297	248,471	250,260	257,056
Total Deposits	$1,261,781	$1,239,249	$1,223,207	$1,232,616	$1,215,208

Percentage of Average Quarterly Deposits

	Quarter Ended				
	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Demand Deposits	15.9%	15.2%	14.9%	15.4%	16.0%
Interest-Bearing Demand Deposits	28.0	29.9	27.8	28.7	25.5
Regular and Money Market Savings	22.8	23.0	21.7	21.4	21.7
Time Deposits of $100,000 or More	14.1	12.7	15.3	14.2	15.6
Other Time Deposits	19.2	19.2	20.3	20.3	21.2
Total Deposits	100.0%	100.0%	100.0%	100.0%	100.0%

For a variety of reasons, including the seasonality of municipal deposits, we typically experience little net growth or a small contraction in average deposit balances in the first quarter of each calendar year, versus significant growth in the second quarter. Deposit balances followed this pattern for the first two quarters of 2008 as the average balance decreased $9.4 million, or 0.8%, in the first quarter of 2008, from the fourth quarter of 2007, which the average deposit balance for the second quarter of 2008 increased $16.0 million, or 1.3%, from the first quarter of 2008. During the third quarter of 2008, the average balance of our municipal deposits decreased by $11.4 million, but this decrease was more than offset by a $33.9 million increase in the average balance of our non-municipal accounts. We did not acquire any branches during the past five quarters, but did previously open an additional branch in Plattsburgh during the first quarter of 2007. During the first two quarters of 2008, as the rates we paid on deposits decreased significantly across all types of deposits, we experienced a shift from time deposits to shorter-maturity deposits, primarily to NOW accounts in the case of municipal deposits and primarily to savings accounts in the case of individual depositors.

Quarterly Cost of Deposits

	Quarter Ended				
	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Demand Deposits	---%	---%	---%	---%	---%
Interest-Bearing Demand Deposits	1.31	1.38	1.69	2.34	2.16
Regular and Money Market Savings	1.19	1.25	1.39	1.52	1.51
Time Deposits of $100,000 or More	2.88	3.11	4.05	4.60	4.88
Other Time Deposits	3.23	3.46	4.23	4.42	4.41
Total Deposits	1.67	1.76	2.25	2.55	2.57

Impact of Interest Rate Changes 2003 2008

Our profitability is affected by the prevailing interest rate environment, both short-term rates and long-term rates, by changes in those rates, and by the relationship between short- and long-term rates (i.e., the yield curve).

Changes in Rates 2003 2008. In mid-2003, due to actions by the Federal Reserve Bank (Fed), the target rate on federal funds (funds which banks loan to one another on an overnight basis) decreased to an almost unprecedented low of 1.00%, and rates paid by banks on short-term deposits similarly decreased to historically low levels. The prevailing low rates on credit provoked a substantial expansion of lending across all sectors of the U.S. economy, especially mortgage and consumer lending. In mid-2004, the Fed reversed course and began to increase short-term rates with a series of 25 basis point increases in the targeted federal funds rate, reaching 5.25% by mid-2006. Rates paid by banks on short-term deposits similarly increased during this period, although rates paid on long-term deposits (and yields earned on long-term loans and assets) did not increase proportionately.

From mid-2006 to fall 2007, the Fed did not take any actions to change short-term rates. In September 2007, however, in response to a weakening economy and a loss of liquidity in the short-term credit market, precipitated in large part by the collapse in the housing market and resulting problems in subprime residential real estate lending, the Fed began lowering the federal funds target rate, rapidly and in significant amounts.

By the December 2007 meeting of the Board of Governors, the rate had decreased 100 basis points, to 4.25%, and in early 2008, the Fed, in response to continuing liquidity concerns in the credit markets, lowered the targeted federal funds rate by an additional 225 basis points, to 2.00%. We began to see an immediate impact in the reduced cost of our deposits, which we expect will moderate into a more gradual reduction as maturing time deposits reprice. We also expect that our loan yields will decline, but that decrease may not be as sizable as the reduction in our cost of deposits, if mid- to long-term rates do not fall as quickly or to the extent that short-term rates fall.

Flattening of the Yield Curve 2005 2007. An important development with regard to the effect of rate changes on our profitability in the mid-2004 to mid-2007 period was the flattening of the yield curve, especially during 2006 and the first half of 2007. After the Fed began increasing short-term interest rates in June 2004, the yield curve did not maintain its traditional upward slope but flattened; that is, as short-term rates increased, longer-term rates stayed unchanged or even decreased. Therefore, the traditional spread between short-term rates and long-term rates (the upward yield curve) essentially disappeared, i.e., the curve flattened. In late 2006 and in early 2007, the yield curve actually inverted, with short-term rates exceeding long-term rates. The flattening of the yield curve was the most significant factor in reducing our net interest income from 2005 through 2007.

Recent Return to Normal Yield Curve. Only at the end of the second quarter of 2007 did the yield on longer-term securities begin to increase over short-term investments. This increase in rate spread was further enhanced when long-term rates held steady after the Fed lowered short-term rates in September 2007. Because market perceptions and expectations are now changing regarding the need to price more risk into long-term debt, long-term rates may be expected to remain steady, or perhaps even rise, even though short-term rates have dropped sharply in recent quarters. Therefore, the yield curve may continue to reflect its more traditional shape for some time. However, even lending institutions such as ours that have avoided subprime lending problems and have enjoyed continued high credit quality in recent periods may nevertheless experience pressure on credit quality in upcoming periods, especially if the national or regional economy continues to weaken, which may reduce the benefit we experience from the return of a positively-sloped yield curve. Thus, no assurances can be given on future improvements in our net interest margins, net interest income or net income generally, particularly as consumer mortgage related borrowings diminish across the U.S. economy and the redeployment of funds by bankers from maturing loans and assets into other high-quality assets becomes progressively more difficult.

Effect of Rate Changes on Margin. In addition to the shape of the yield curve, our net interest margin has traditionally been sensitive to and impacted by changes in prevailing market interest rates. Generally, there has been a negative correlation between changes in prevailing interest rates and our net interest margin, especially when rates begin to move in a different direction. Typically, when prevailing rates begin to decline, our net interest margin generally increases in immediately ensuing periods, and vice versa, as in each case earning assets reprice more slowly than interest-bearing sources of funds. This was the case for our net interest margin during the 2002 to mid-2003 period, when prevailing short-term market rates began to decline and our margin increased, and during the mid-2003 to 2004 period, when rates began to increase and our margins experienced a negative effect. In 2005 through mid-2007, however, even as the Fed held rates steady, our net interest margin continued to suffer as a result of the flattening yield curve. Our margin reached a low point in the fourth quarter of 2006, at 3.24%, and then increased slightly to 3.32% for each of the first two quarters of 2007. In the third quarter of 2007 the margin decreased once again, to 3.29%, before returning to 3.32% in the fourth quarter.

Improvement in Our Margins Late 2007 2008. Since September 30, 2007 our margin has steadily improved, principally due to the fact the rates we paid on our interest-bearing liabilities began to reprice downward rapidly. The dramatic reduction in short-term interest rates since September 2007 had an immediate and significant positive impact on our net interest income and net interest margin in the first two quarters of 2008. Net interest margin for the 2008 first quarter was 3.56%, an increase of 24 basis points from the previous quarter, and then increased by another 36 basis points to 3.92% for the second quarter of 2008. The margin held steady at 3.93% for the third quarter of 2008. Our ability to reduce the rates paid on some of our non-maturity deposit products, if short-term funding rates continue to decline in upcoming periods, is limited due to the already low levels for those products, whereas rates earned on our earning assets will likely index downwards to the full extent of the decrease in prevailing rates.

Non-Deposit Sources of Funds

We have borrowed funds from the Federal Home Loan Bank ("FHLB") under a variety of programs, including fixed and variable rate short-term borrowings and borrowings in the form of "structured advances." These structured advances have original maturities of 3 to 10 years and are callable by the FHLB at certain dates. If the advances are called, we may elect to receive replacement advances from the FHLB at the then prevailing FHLB rates of interest.

The $20 million of trust preferred securities identified on our consolidated balance sheet as of September 30, 2008 (referred to as Junior Subordinated Obligations to Unconsolidated Subsidiary Trusts) qualify as regulatory capital under the bank regulators capital adequacy guidelines, as discussed under Capital Resources beginning on page 31 of this Report. These trust preferred securities are subject to early redemption by us if the proceeds cease to qualify as Tier 1 capital of Arrow for any reason, including if bank regulatory authorities were to reverse their current position and decide that trust preferred securities do not qualify as regulatory capital, or in the event of an adverse change in tax laws.

Loan Portfolio Trends

The following two tables present, for each of the last five quarters, the quarterly average balances by loan type and the percentage of total loans represented by each loan type.

Quarterly Average Loan Balances

(Dollars in Thousands)

	Quarter Ended				
	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Commercial and Commercial Real Estate	$ 306,160	$ 292,869	$ 277,003	$ 273,068	$ 265,060
Residential Real Estate	334,489	326,003	322,819	318,883	315,576
Home Equity	48,358	47,895	46,535	46,152	45,864
Indirect Consumer Loans	342,526	332,458	337,060	342,595	339,955
Other Consumer Loans [1]	51,758	53,578	55,493	55,963	54,944
Total Loans	$1,083,291	$1,052,803	$1,038,910	$1,036,661	$1,021,399

Percentage of Quarterly Average Loans

	Quarter Ended				
	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Commercial and Commercial Real Estate	28.3%	27.8%	26.7%	26.3%	25.9%
Residential Real Estate	30.9	31.0	31.1	30.8	30.9
Home Equity	4.4	4.5	4.5	4.4	4.5
Indirect Consumer Loans	31.6	31.6	32.4	33.1	33.3

Other Consumer Loans	4.8	5.1	5.3	5.4	5.4
Total Loans	100.0%	100.0%	100.0%	100.0%	100.0%

[1] The category Other Consumer Loans , in the tables above, includes home improvement loans secured by mortgages, which are otherwise reported with residential real estate loans in tables of period-end balances.

Maintenance of High Quality in the Loan Portfolio: During the second half of 2007 and through the first three quarters of 2008, the U.S. experienced significant disruption and volatility in its financial and capital markets. A major cause of the disruption was a significant decline in residential real estate values across much of the U.S., which in turn triggered widespread defaults on subprime mortgage loans and steep devaluations of portfolios containing these loans and securities collateralized by them. In recent months, as real estate values have continued to fall in most areas of the U.S., problems have spread from subprime loans to better quality mortgage portfolios, and in some cases prime mortgage loans, as well as home equity and credit card loans. Many lending institutions suffered sizable charge-offs and losses in their loan and investment securities portfolios in the second half of 2007 and first three quarters of 2008 as a result of their origination or investment in those kinds of loans or securities.

Through September 2008, we have not experienced any significant deterioration in our loan or investment portfolios, except for the impaired Lehman bond cited earlier in this Report. We have never engaged in subprime mortgage lending as a business line and we have not purchased any subprime mortgage loans. On occasion we have made loans to borrowers having a FICO score of 660 or below or have had extensions of credit outstanding to borrowers who have developed credit problems after origination resulting in deterioration of their FICO scores. We also on occasion have extended community development loans to borrowers whose creditworthiness is below our normal standards as part of the community support program we have developed in fulfillment of our statutorily-mandated duty to support low- and moderate-income neighborhoods within our service area. However, we are a prime lender and apply prime lending standards and this, together with the fact that the service area in which we make most of our loans has not experienced as severe a decline in property values as other parts of the U.S., are the principal reasons that we have not experienced any significant deterioration in our loan portfolio through the Report date.

If, however, the current downturn in the U.S. housing market should continue and the U.S. and/or our local economy should weaken notably in upcoming periods, we can give no assurances about the continuing high quality of our loan portfolio. In such an event we may experience elevated charge-offs, higher provisions to our loan loss reserve, and increasing expense related to asset maintenance and supervision.

Residential Real Estate Loans: In recent years, residential real estate and home equity loans have represented the largest segment of our loan portfolio. Residential mortgage demand has been moderate since 2004, after a several year period when demand was high. However, during 2004 and 2005 and the first quarter of 2006, we sold many of our 30-year, fixed-rate mortgage originations, while retaining the servicing rights. By the end of the first quarter of 2006, as yields on longer-term residential real estate loans began to rise, we stopped selling our 30-year mortgage originations and decided to retain them in our portfolio. During 2008, the $48.4 million of new residential real estate loan originations offset normal principal amortization and prepayments on pre-existing loans. We expect that, if we continue to retain all or most originations, we will be able to maintain the current level of residential real estate loans and may experience some continued growth. However, if the economy or local real estate market suffers a major downturn and the demand for residential real estate loans in our service area decreases, our portfolio also may decrease, which may negatively impact our financial performance.

Indirect Loans: In the last quarter of 2007 and the first two quarters of 2008, we encountered enhanced rate competition on indirect (auto) loans from other lenders, including finance affiliates of the auto manufacturers who increased their offerings of heavily subsidized, low- or zero-rate loans. This increasingly competitive environment, combined with softening demand for vehicles, especially for SUVs and light trucks, had a negative effect on our indirect originations, and we experienced decreases in indirect balances in the first two quarters of 2008. However during the third quarter, as some of the major lenders in the indirect market pulled back, including the auto companies financing affiliates, our share of the indirect loan market increased and our portfolio at September 30, 2008 exceeded the balance at December 31, 2007 by $14.8 million, or 4.4%.

At September 30, 2008, indirect loans represented the second largest category of loans in our portfolio and a significant component of our business. However, if the recent dramatic reduction in auto demand continues, our indirect loan portfolio is likely to experience limited, if any, overall growth, either in real terms or as a percentage of the total portfolio, regardless of whether the auto company affiliates resume their offering of highly-subsidized vehicle loans. Such weakened demand for indirect loans could negatively impact our financial performance.

Commercial, Commercial Real Estate and Construction and Land Development Loans: We have experienced moderate to strong demand for commercial loans for the past several years, and thus commercial and commercial real estate loan balances have grown significantly, both in dollar amount and as a percentage of the overall loan portfolio. This pattern continued during the third quarter of 2008 as the average balance in this category grew $13.3 million from the prior quarter s average. Substantially all commercial and commercial real estate loans in our portfolio are extended to businesses or borrowers located in our regional market. Many of the loans in the commercial portfolio have variable rates tied to prime, FHLB or U.S. Treasury indices. We have not experienced any significant weakening in our commercial loan portfolio in recent quarters, although both the demand for such loans as well as the quality of the portfolio may be negatively affected if the national or regional economy weakens in upcoming periods.

Quarterly Taxable Equivalent Yield on Loans

	Quarter Ended				
	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Commercial and Commercial Real Estate	6.61%	6.74%	7.13%	7.15%	7.26%
Residential Real Estate	6.00	6.07	6.08	6.01	6.03
Home Equity	4.91	5.24	6.84	7.33	7.82
Indirect Consumer Loans	6.35	6.22	6.20	6.20	6.05
Other Consumer Loans	7.36	7.30	7.33	7.35	7.35
Total Loans	6.30	6.33	6.50	6.50	6.51

In the third quarter of 2008, the average yield on our loan portfolio declined by 3 basis points, from 6.33% to 6.30%, due primarily to competitive pressures on rates for new commercial and commercial real estate loans. The yields on new 30 year fixed-rate residential real estate loans (the choice of most of our mortgage customers) also fell during the quarter. However, the decrease in average yield on loans was not as pronounced as the nine basis point decline in our cost of deposits during the quarter, continuing the trend from preceding quarters.

In general, the yield (tax-equivalent interest income divided by average loans) on our loan portfolio and other earning assets is impacted by changes in prevailing interest rates, as previously discussed in this Report on page 24 under the heading "Impact of Interest Rate Changes 2003 - 2008." We expect that such will continue to be the case; that is, that loan yields will continue to rise and fall with changes in prevailing market rates, although the timing and degree of responsiveness will continue to be influenced by a variety of other factors, including the makeup of the loan portfolio, the shape of the yield curve, changing perceptions of risk inherent in loans of all types (specifically, enhanced performance risk in a highly stressed economy) and consumer expectations and preferences. Generally, however, the portfolio yield always adjusts toward prevailing market rates, as a significant amount of cash flow from normal amortization and prepayments on loans reprices at current rates, in the form or new loans generated at the current yields.

Investment Portfolio Trends

The following table presents the changes in the securities available-for-sale and the securities held-to-maturity investment portfolios from December 31, 2007 to September 30, 2008 (in thousands):

	Period End Balances			Net Unrealized Gain (Loss)		
	Sep 2008	Dec 2007	Change	Sep 2008	Dec 2007	Change
Securities Available-for-Sale:						
U.S. Treasury and Agency Obligations	$ 16,376	$ 39,497	$(23,121)	$ 1	$ 11	$ (10)
State and Municipal Obligations	16,788	24,206	(7,418)	19	(10)	29
Collateralized Mortgage Obligations	190,226	138,971	51,255	(1,490)	62	(1,552)
Other Mortgage-Backed Securities	109,030	112,458	(3,428)	(304)	2	(306)
Corporate and Other Debt Securities	7,287	11,574	(4,287)	(1,054)	8	(1,062)
Mutual Funds and Equity Securities	10,819	11,364	(545)	(320)	(134)	(186)
Total	$350,526	$338,070	$12,456	$(3,148)	$ (61)	$(3,087)
Securities Held-to-Maturity:						
State and Municipal Obligations	$131,438	$114,611	$16,827	$(1,358)	$366	$(1,724)

Other-Than-Temporary Impairment

Each quarter we evaluate all investment securities, both in the available-for-sale portfolio and the held-to-maturity portfolio, if the fair value thereof is less than the amortized cost to determine any other-than-temporary impairment as defined under generally accepted accounting principles. As previously cited on page 21 of this Report, in the third quarter of 2008 we recognized an other-than-temporary impairment loss on a Lehman bond, the value of which was written down from its $2 million face value to a fair value of $800 thousand. For both periods presented in the above table, other mortgage-backed securities consisted solely of agency mortgage pass-through securities. Pass-through securities provide to the investor monthly portions of principal and interest pursuant to the contractual obligations of the underlying mortgages. Collateralized mortgage obligations (CMOs) separate the repayments into two or more components (tranches), where each tranche has a separate estimated life and yield. Our practice has been to purchase pass-through securities and CMOs that are guaranteed by federal agencies and tranches of CMOs with shorter maturities. Included in corporate and other debt securities are corporate bonds and trust preferred securities which were highly rated at the time of purchase and other than the impaired securities discussed above.

Investment Sales, Purchases and Maturities: Available-for-Sale Portfolio

(In Thousands)

	Nine Months Ended	
	Sep 2008	Sep 2007
Sales		
Mutual Funds and Equity Securities	$5,547	$2,225
Net Losses on Securities Transactions	$29	$---
Purchases		
Collateralized Mortgage Obligations	$ 73,616	$ ---
Other Mortgage-Backed Securities	15,481	39,494
U.S. Agency Securities	10,875	500
State and Municipal Obligations	5,784	8,975
Other	3,943	9,619
Total Purchases	$109,699	$58,588
Maturities & Calls	$87,125	$38,689

Asset Quality

The following table presents information related to our allowance and provision for loan losses for the past five quarters.

Summary of the Allowance and Provision for Loan Losses

(Dollars in Thousands)

	Sep 2008	Jun 2008	Mar 2008	Dec 2007	Sep 2007
Loan Balances:					
Period-End Loans	$1,106,506	$1,062,999	$1,043,732	$1,038,844	$1,034,548
Average Loans, Year-to-Date	1,058,426	1,045,857	1,038,910	1,020,856	1,015,529
Average Loans, Quarter-to-Date	1,083,291	1,052,803	1,038,910	1,036,661	1,021,399
Period-End Assets	1,673,051	1,630,981	1,628,592	1,584,846	1,577,049
Allowance for Loan Losses, Year-to-Date:					
Allowance for Loan Losses, Beginning of Period	$12,401	$12,401	$12,401	$12,278	$12,278
Provision for Loan Losses, YTD	791	538	290	513	322
Loans Charged-off, YTD	(825)	(563)	(295)	(830)	(610)
Recoveries of Loans Previously Charged-off	418	349	84	440	351
Net	(407)	(214)	(211)	(390)	(259)

Charge-offs, YTD					
Allowance for Loan Losses, End of Period	$12,785	$12,725	$12,480	$12,401	$12,341
Allowance for Loan Losses, Quarter-to-Date:					
Allowance for Loan Losses, Beginning of Period	$12,725	$12,480	$12,401	$12,341	$12,315
Provision for Loan Losses, QTD	253	248	290	191	136
Loans Charged-off, QTD	(263)	(268)	(295)	(220)	(185)
Recoveries of Loans Previously Charged-off	70	265	84	89	75
Net Charge-offs, QTD	(193)	(3)	(211)	(131)	(110)
Allowance for Loan Losses, End of Period	$12,785	$12,725	$12,480	$12,401	$12,341
Nonperforming Assets, at Period-End:					
Nonaccrual Loans	$2,424	$1,941	$2,060	$1,939	$1,900
Loans Past due 90 Days or More					
	455	593	1,006	245	121
and Still Accruing Interest					
Total Nonperforming Loans	2,879	2,534	3,066	2,184	2,021
Nonaccrual Investments	800	---	---	---	---
Repossessed Assets	61	53	25	63	63

Other Real Estate Owned	270	242	149	89	26
Total Nonperforming Assets	$4,010	$2,829	$3,240	$2,336	$2,110
Asset Quality Ratios:					
Allowance to Nonperforming Loans	444.08%	502.17%	**of**		

Shares or Units of Stock That Have Not Vested	**Market Value of Shares or Units of Stock That Have Not Vested ($)**	**Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested[5]**	**Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested**

Name	**exercisable**	**unexercisable**	**options (#)**	**($)**	**date**
Stanton E. Ross Chairman, CEO and President	15,000	—	—	$ 4.80	1/12/
	11,250	7,500	—	$ 13.20	1/10/
	3,750	—	—	$ 14.24	5/5/2
	37,500	—	—	$ 54.40	1/2/2
	21,875	—	—	$ 32.40	10/1
	25,000	—	—	$ 12.80	3/3/2
	24,228	—	—	$ 8.00	8/31/
Thomas J. Heckman CFO, Treasurer and Secretary	7,500	5,000	—	$ 13.20	1/10/
	3,750		—	$ 24.80	7/30/
	3,750		—	$ 14.24	5/5/2
	2,500		—	$ 12.72	3/30/
	12,500		—	$ 54.40	1/2/2

2,500	—	$	32.40	10/15

(1) These stock option awards were made under the Digital Ally, Inc. Stock Option and Restricted Stock Plans and vest over a the prescribed period contingent upon whether the individual is still employed by the Company at that point.

(2) Market value determined based on closing market price of our common stock of $15.32 per share on December 31, 2014.

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The following table presents information concerning the stock options exercised and the vesting of stock awards during 2014 for the Named Executive Officers as of December 31, 2014:

Options Exercises and Stock Vested

	Option Awards		Stock Awards	
	Number of Shares acquired on exercise (#)	Value realized on exercise ($)	Number of Shares acquired on vesting (#)	Value on vesting ($)
Stanton E. Ross Chairman, CEO & President	—	$—	20,000	$170,000(2)
Thomas J. Heckman CFO, Treasurer and Secretary	15,000	$208,350(1)	20,000	$170,000(2)

(1) Based on the closing price of our common stock on December 2, 2014, the date exercised.
(2) Based on the closing price of our common stock on January 26, 2014, the date of vesting.

Stock Option Plans

Securities Authorized for Issuance under Equity Compensation Plans

As of December 31, 2014, the Company had adopted six separate stock option and restricted stock plans: (i) the 2005 Stock Option and Restricted Stock Plan (the "2005 Plan"), (ii) the 2006 Stock Option and Restricted Stock Plan (the "2006 Plan"), (iii) the 2007 Stock Option and Restricted Stock Plan (the "2007 Plan"), (iv) the 2008 Stock Option and Restricted Stock Plan (the "2008 Plan"), (v) the 2011 Stock Option and Restricted Stock Plan (the "2011 Plan") and (vi) the 2013 Stock Option and Restricted Stock Plan (the "2013 Plan"). These Plans permit the grant of stock options or restricted stock to its employees, non-employee directors and others for up to a total of 1,075,000 shares of common stock. The Company believes that such awards better align the interests of its employees with those of its stockholders. Option awards have been granted with an exercise price equal to the market price of the Company's stock at the date of grant with such option awards generally vesting based on the completion of continuous service and having ten-year contractual terms. These option awards provide for accelerated vesting if there is a change in control (as defined in the Plans). The Company has registered all shares of common stock that are issuable under its Plans with the SEC. A total of 2,587 options remain available for grant under the various Plans as of December 31, 2014.

The Plans authorize us to grant (i) to the key employees incentive stock options (except for the 2007 Plan) to purchase shares of common stock and nonqualified stock options to purchase shares of common stock and restricted stock awards, and (ii) to non-employee directors and consultants non-qualified stock options and restricted stock. The Compensation Committee of our Board of Directors administers the Plans by making recommendations to the Board of Directors or determinations regarding the persons to whom options or restricted stock should be granted and the amount, terms, conditions and restrictions of the awards.

The Plans allow for the grant of incentive stock options (except for the 2007 Plan), non-qualified stock options and restricted stock awards. Incentive stock options granted under the Plans must have an exercise price at least equal to 100% of the fair market value of the common stock as of the date of grant. Incentive stock options granted to any person who owns, immediately after the grant, stock possessing more than 10% of the combined voting power of all classes of our stock, or of any parent or subsidiary corporation, must have an exercise price at least equal to 110% of the fair market value of the common stock on the date of grant. Non-statutory stock options may have exercise prices as determined by our Compensation Committee.

The Compensation Committee is also authorized to grant restricted stock awards under the Plans. A restricted stock award is a grant of shares of the common stock that is subject to restrictions on transferability, risk of forfeiture and other restrictions and that may be forfeited in the event of certain terminations of employment or service prior to the end of a restricted period specified by the Compensation Committee. We have filed registration statements on Form S-8 and amendments to a previously filed Form S-8 with the SEC which registered all shares to be issued upon exercise of the stock options underlying the 2005 Plan, 2006 Plan, 2007 Plan, 2008 Plan, 2011 Plan and 2013 Plan.

Equity Compensation Plan Information as of December 31, 2014

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a) (c)
Equity compensation plans approved by stockholders	280,384	$ 19.08	95,196
Equity compensation plans not approved by stockholders	90,359	$ 18.64	2,217
Total all plans	370,743	$ 18.97	97,413

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The number of stock options and restricted stock awards that an employee, director, or consultant may receive under our Plans is in the discretion of the administrator and therefore cannot be determined in advance, although the Board of Directors' policy in 2014 was to grant officers an award of 55,000 restricted shares and directors an award of 17,000 restricted shares, all subject to vesting requirements.

The following table sets forth (a) the aggregate number of shares subject to options granted under the Plans during the year-ended December 31, 2014 and (b) the average per share exercise price of such options.

Stock Option and Restricted Stock Grants

Name of Individual or Group	Number of Restricted Shares of Common Stock Granted	Number of Options Granted	Average per Share Exercise Price
Stanton E. Ross, Chairman of the Board, CEO & President	55,000	—	$ —
Leroy C. Richie, Director	17,000	—	$ —
Elliot M. Kaplan, Director	17,000	—	$ —
Daniel F. Hutchins, Director	17,000	—	$ —
Thomas J. Heckman, Vice President, CFO, Treasurer & Secretary	55,000	—	$ —
All executive officers, as a group	161,000	—	$ —
All directors who are not executive officers, as a group	51,000	—	$ —
All employees who are not executive officers, as a group	27,500	24,000	$ 3.25

Employment Contracts; Termination of Employment and Change-in-Control Arrangements

We do not have any employment agreements with any of our executive officers. However, on December 23, 2008, we entered into retention agreements with the following executive officers: Stanton E. Ross and Thomas J. Heckman.

Retention Agreements - Potential Payments Upon Termination or Change of Control

The following table sets forth for each named executive officer potential post-employment payments and payments on a change in control and assumes that the triggering event took place on January 1, 2015.

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Retention Agreement Compensation

Name	Change in control payment due based upon successful completion of transaction	Severance payment due based on termination after Change of Control occurs	Total
Stanton E. Ross	$ 43,750	$ 175,000	$218,750
Thomas J. Heckman	$ 43,750	$ 175,000	$218,750
Total	$ 87,500	$ 350,000	$437,500

The retention agreements guarantee the executive officers specific payments and benefits upon a Change in Control of the Company. The retention agreements also provide for specified severance benefits if, after a Change in Control of the Company occurs, the executive officer voluntarily terminates employment for “Good Reason” or is involuntarily terminated without “Cause.”

Under the retention agreements, a “Change in Control” means (i) one party alone, or acting with others, has acquired or gained control over more than 50% of the voting shares of the Company; (ii) the Company merges or consolidates with or into another entity or completes any other corporate reorganization, if more than 50% of the combined voting power of the surviving entity’s securities outstanding immediately after such merger, consolidation or other reorganization is owned by persons who were not stockholders of the Company immediately prior to such merger, consolidation or other reorganization; (iii) a majority of the Company’s Board of Directors is replaced and/or dismissed by the stockholders of the Company without the recommendation of or nomination by the Company’s current Board of Directors; (iv) the Company’s Chief Executive Officer (the “CEO”) is replaced and/or dismissed by stockholders without the approval of the Company’s Board of Directors; or (v) the Company sells, transfers or otherwise disposes of all or substantially all of the consolidated assets of the Company and the Company does not own stock in the purchaser or purchasers having more than 50% of the voting power of the entity owning all or substantially all of the consolidated assets of the Company after such purchase.

“Good Reason” means either (i) a material adverse change in the executive’s status as an executive or other key employee of the Company, including without limitation, a material adverse change in the executive’s position, authority, or aggregate duties or responsibilities; (ii) any adverse change in the executive’s base salary, target bonus or benefits; or (iii) a request by the Company to materially change the executive’s geographic work location.

"Cause" means (i) the executive has acted in bad faith and to the detriment of the Company; (ii) the executive has refused or failed to act in accordance with any specific lawful and material direction or order of his or her supervisor; (iii) the executive has exhibited, in regard to employment, unfitness or unavailability for service, misconduct, dishonesty, habitual neglect, incompetence, or has committed an act of embezzlement, fraud or theft with respect to the property of the Company; (iv) the executive has abused alcohol or drugs on the job or in a manner that affects the executive's job performance; and/or (v) the executive has been found guilty of or has plead *nolo contendere* to the commission of a crime involving dishonesty, breach of trust, or physical or emotional harm to any person. Prior to termination for Cause, the Company shall give the executive written notice of the reason for such potential termination and provide the executive a 30-day period to cure such conduct or act or omission alleged to provide grounds for such termination.

If any Change in Control occurs and the executive continues to be employed as of the completion of such Change in Control, upon completion of such Change in Control, as payment for the executive’s additional efforts during such Change in Control, the Company shall pay the executive a Change in Control benefit payment equal to three months of the his base salary at the rate in effect immediately prior to the Change in Control completion date, payable in a lump sum net of required tax withholdings. If any Change in Control occurs, and if, during the one-year period following the Change in Control, the Company terminates the executive’s employment without Cause or the executive submits a resignation for Good Reason (the effective date of such termination or resignation, the “Termination Date”), then:

(a) The Company shall pay the executive severance pay equal to 12 months of the his base salary at the higher of the rate in effect immediately prior to the Termination Date or the rate in effect immediately prior to the occurrence of the event or events constituting Good Reason, payable on the Termination Date in a lump sum net of required tax withholdings, plus all other amounts then payable by the Company to the executive less any amounts then due and owing from the executive to the Company;

(b) The Company shall provide continuation of the executive’s health benefits at the Company’s expense for 18 months following the Termination Date; and

(c) The executive’s outstanding employee stock options shall fully vest and be exercisable for a 90-day period following the Termination Date.

The executive is not entitled to the above severance benefits for a termination based on death or disability, resignation without Good Reason or termination for Cause. Following the Termination Date, the Company shall also pay the executive all reimbursements for expenses in accordance with the Company’s policies, within ten days of submission of appropriate evidence thereof by the executive.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth, as of March 30, 2015, the number and percentage of outstanding shares of common stock beneficially owned by each person known by us to beneficially own more than five percent of such stock. We have no other class of capital stock outstanding.

The following table sets forth, as of March 30, 2015, the number and percentage of outstanding shares of common stock beneficially owned by each person known by us to beneficially own more than five percent of such stock. We have no other class of capital stock outstanding:

Security Ownership of Certain Beneficial Owners

Name and address of beneficial owner	Amount and nature of beneficial	**Percent of class**
5% Stockholders (excluding executive officers and directors):		
None		

The following table sets forth, as of March 30, 2015, the number and percentage of outstanding shares of common stock beneficially owned by each director of the Company, each named officer of the Company, and all our directors and executive officers as a group. We have no other class of capital stock outstanding.

Security Ownership of Management

Name and address of beneficial owner	Amount and nature of beneficial ownership	Percent of class	
Executive Officers & Directors: (1)			
Stanton E. Ross (2)	261,248	6.2	%
Leroy C. Richie (3)	83,442	2.0	%
Elliot M. Kaplan (4)	65,387	1.5	%
Daniel F. Hutchins (5)	52,450	1.2	%
Thomas J. Heckman (6)	204,192	4.8	%
All officers and directors as a group (five individuals)	666,719	15.7	%

(1) The address of these persons is c/o Digital Ally, Inc. 9705 Loiret Blvd, Lenexa, KS 66219.

(2) Mr. Ross's total shares include: (i) vested options to purchase 146,103 shares of common stock and (ii) 55,000 shares of restricted common stock that vest from June 2015 through February 2017. Mr. Ross has pledged 103,651 common shares and outstanding and exercisable options to purchase 24,228 common shares at $8.00 per share to an individual as collateral for personal loans.

(3) Mr. Richie's total shares include: (i) vested options to purchase 33,848 shares of common stock and (ii) 17,000 shares of restricted common stock that vest on May 1, 2015.

(4) Mr. Kaplan's total shares include: (i) vested options to purchase 26,075 shares of common stock and (ii) 17,000 shares of restricted common stock that vest on May 1, 2015. Mr. Kaplan has pledged 22,312 common shares to financial institutions as collateral for personal loans.

(5) Mr. Hutchins' total shares include: (i) vested options to purchase 22,500 shares of common stock and (ii) 17,000 shares of restricted common stock that vest on May 1, 2015.

(6) Mr. Heckman's total shares include (i) vested options to purchase 37,500 shares of common stock; (ii) 38,759 shares of common stock held in the Company's 401(k) Plan (on March 30, 2015) as to which Mr. Heckman has voting power as trustee of the 401(k) Plan; and (iii) 55,000 shares of restricted common stock that vest from June 2015 through February 2017. Mr. Heckman has pledged 56,148 common shares to financial institutions as collateral for a personal loan.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Act of 1934, as amended, requires our executive officers and directors, and persons who own more than ten percent of our common stock, to file with the Securities and Exchange Commission reports of ownership of, and transactions in, our securities and to provide us with copies of those filings. To our knowledge, based solely on our review of the copies of such forms received by us, or written representations from certain reporting persons, we believe that during the year ended December 31, 2014, all filing requirements applicable to our officers, directors and greater than ten percent beneficial owners were complied with.

TRANSACTIONS WITH RELATED PERSONS

Certain Relationships and Related Person Transactions

The Company engaged in no reportable transactions with related persons during the years ended December 31, 2014 and 2013.

OTHER MATTERS

The Board of Directors is not aware of any other matters to be presented for action at the annual meeting. However, if any other matter is properly presented at the annual meeting, it is the intention of the persons named in the enclosed proxy to vote the shares they represent as the Board of Directors may recommend.

ADVANCE NOTICE PROVISIONS FOR STOCKHOLDER PROPOSALS AND NOMINATIONS

The bylaws of the Company provide that in order for a stockholder to nominate directors at an annual meeting or to propose business to be brought before an annual meeting, the stockholder must give timely, written notice to the Secretary of the Company and such notice must be received at the principal executive offices of the Company not less than 120 days before the date of its release of the proxy statement to stockholders in connection with its previous year’s annual meeting of stockholders.

Such stockholder’s notice shall include, with respect to each matter that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the annual meeting and the reasons for conducting such business at the annual meeting, and with respect to each person whom the stockholder proposes to nominate for election as a director, all information relating to such person, including such person’s written consent to being named in the proxy statement as a nominee and to serving as a director, that is required under the Securities Exchange Act of 1934, as amended.

In addition, the stockholder must include in such notice the name and address, as they appear on the Company's records, of the stockholder proposing such business or nominating such persons, and the name and address of the beneficial owner, if any, on whose behalf the proposal or nomination is made, the class and number of shares of capital stock of the Company that are owned beneficially and of record by such stockholder of record and by the beneficial owner, if any, on whose behalf the proposal or nomination is made, and any material interest or relationship that such stockholder of record and/or the beneficial owner, if any, on whose behalf the proposal or nomination is made may respectively have in such business or with such nominee. At the request of the Board of Directors, any person nominated for election as a director shall furnish to the Secretary of the Company the information required to be set forth in a stockholder's notice of nomination which pertains to the nominee.

FUTURE PROPOSALS OF STOCKHOLDERS

The deadline for stockholders to submit proposals to be considered for inclusion in the proxy statement for the next annual meeting of stockholders is December 24, 2015.

ANNUAL REPORT

This proxy statement is accompanied by a copy of our annual report for the fiscal year ended December 31, 2014.

BY ORDER OF THE BOARD OF DIRECTORS

April 29, 2015	**Chairman of the Board, Chief Executive Officer and President**
Lenexa, Kansas	

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Appendix A

Digital Ally, Inc.

2015 Stock Option and Restricted Stock Plan

1. Purposes.

(a) Background. This 2015 Stock Option and Restricted Stock Plan was adopted on March 27, 2015 by the Board of Directors, subject to the approval of the Company's stockholders. Options granted under the Plan prior to the stockholders' approval will be effective upon approval of the stockholders as of their respective dates of grant.

(b) Eligible Award Recipients. The persons eligible to receive Awards are the Employees and Directors of the Company and its Affiliates.

(c) Available Awards. The purpose of the Plan is to provide a means by which eligible recipients may be given an opportunity to benefit from increases in value of the Common Stock through the granting of the following: (i) Incentive Stock Options, (ii) Nonqualified Stock Options, (iii) rights to acquire restricted stock, and (iv) stock appreciation rights.

(d) General Purpose. The Company, by means of the Plan, seeks to retain the services of the group of persons eligible to receive Awards, to secure and retain the services of new members of this group and to provide incentives for such persons to exert maximum efforts for the success of the Company and its Affiliates.

2. Definitions.

(a) "*Affiliate*" means any entity that controls, is controlled by, or is under common control with the Company.

(b) "*Award*" means any right granted under the Plan, including an Option, a right to acquire restricted Common Stock, and a stock appreciation right.

(c) "*Award Agreement*" means a written agreement between the Company and a holder of an Award (other than an Option) evidencing the terms and conditions of an individual Award grant.

(d) "*Board*" means the board of directors of the Company.

(e) "*Code*" means the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated thereunder.

(f) "*Committee*" means a pre-existing or newly formed committee of members of the Board appointed by the Board in accordance with subsection 3(c).

(g) "*Common Stock*" means the shares of the Company's common stock par value $0.001 and other rights with respect to such shares.

(h) "*Company*" means Digital Ally, Inc., a Nevada corporation.

(i) "*Continuous Service*" means that the Participant's service with the Company or an Affiliate, whether as an Employee or Director is not interrupted or terminated. Unless otherwise provided in an Award Agreement or Option Agreement, as applicable, the Participant's Continuous Service shall not be deemed to have terminated merely because of a change in the capacity in which the Participant renders service to the Company or an Affiliate as an Employee or Director or a change in the entity for which the Participant renders such service, provided that there is no interruption or termination of the Participant's service to the Company or an Affiliate as an Employee or Director. The Board, in its sole discretion, may determine whether Continuous Service shall be considered interrupted in the case of any leave of absence, including sick leave, military leave or any other personal leave.

(j) "*Covered Employee*" means the Company's chief executive officer and the four (4) other highest compensated officers of the Company for whom total compensation is required to be reported to stockholders under the Exchange Act, as determined for purposes of Section 162(m) of the Code.

(k) "*Director*" means a member of the Board of the Company.

(l) "*Disability*" means the Participant's inability, due to illness, accident, injury, physical or mental incapacity or other disability, to carry out effectively the duties and obligations to the Company and its Affiliates performed by such person immediately prior to such disability for a period of at least six (6) months, as determined in the good faith judgment of the Board.

(m) "*Dollars*" or **"*$*"** means United States dollars.

(n) "*Employee*" means any person employed by the Company or an Affiliate. Service as a Director or payment of a director's fee by the Company or an Affiliate alone shall not be sufficient to constitute "employment" by the Company or an Affiliate.

(o) "*Exchange Act*" means the Securities Exchange Act of 1934, as amended.

(p) "*Fair Market Value*" means, as of any date, the value of the Common Stock determined as follows:

(i) If the Common Stock is listed on any established stock exchange, or traded on the Nasdaq Global Market, the Nasdaq Capital Market or the Nasdaq OTC Bulletin Board, the Fair Market Value of the Common Stock shall be the closing sales price for such stock (or the closing bid, if no sales were reported) as quoted on such exchange or market (or the exchange or market with the greatest volume of trading in Common Stock if such stock is traded on more than one such exchange or market) on the last market trading day prior to the day of determination, as reported by such exchange or market or such other source as the Board reasonably deems reliable.

(ii) In the absence of such markets for the Common Stock, the Fair Market Value shall be determined in good faith by the Board.

(q) "*Incentive Stock Option*" means an option designated as an incentive stock option in an Option Agreement and that is granted in accordance with the requirements of, and that conforms to the applicable provisions of, Section 422 of the Code.

(r) "*Independent Director*" means (i) a Director who satisfies the definition of Independent Director or similar definition under the applicable stock exchange or Nasdaq rules and regulations upon which the Common Stock is traded from time to time and (ii) a Director who either (A) is not a current employee of the Company or an "affiliated corporation" (within the meaning of Treasury Regulations promulgated under Section 162(m) of the Code), is not a former employee of the Company or an "affiliated corporation" receiving compensation for prior services (other than benefits under a tax qualified pension plan), was not an officer of the Company or an "affiliated corporation" at any time and is not currently receiving direct or indirect remuneration from the Company or an "affiliated corporation" for services in any capacity other than as a Director or (B) is otherwise considered an "outside director" for purposes of Section 162(m) of the Code.

(s) "*Nonqualified Stock Option*" means an option that is not designated in an Option Agreement as an Incentive Stock Option or was not granted in accordance with the requirements of, and does not conform to the applicable provisions of, Section 422 of the Code.

(t) "*Officer*" means a person who is an officer of the Company within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder.

(u) "*Option*" means an Incentive Stock Option or a Nonqualified Stock Option granted pursuant to the Plan.

(v) "*Option Agreement*" means a written agreement between the Company and an Optionholder evidencing the terms and conditions of an individual Option grant.

(w) "*Optionholder*" means a person to whom an Option is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Option.

(x) "*Participant*" means a person to whom an Award is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Award.

(y) "*Plan*" means this Digital Ally, Inc. 2015 Stock Option and Restricted Stock Plan.

(z) "*Rule 16b-3*" means Rule 16b-3 promulgated under the Exchange Act or any successor to Rule 16b-3, as in effect from time to time.

(aa) "*Securities Act*" means the Securities Act of 1933, as amended.

(bb) "*Ten Percent Stockholder*" means a person who owns (or is deemed to own pursuant to Section 424(d) of the Code) stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or any parent corporation or any subsidiary corporation, both as defined in Section 424 of the Code.

3. Administration.

(a) Administration by Board. The Board shall administer the Plan unless and until the Board delegates administration to a Committee, as provided in subsection 3(c). The Board may, at any time and for any reason in its sole discretion, rescind some or all of such delegation.

(b) Powers of Board. The Board shall have the power, subject to, and within the limitations of, the express provisions of the Plan:

(i) To determine from time to time which of the persons eligible under the Plan shall be granted Awards; when and how each Award shall be granted; what type or combination of types of Award shall be granted; the provisions of each Award granted (which need not be identical), including the time or times when a person shall be permitted to receive Common Stock pursuant to an Award; and the number of shares of Common Stock with respect to which an Award shall be granted to each such person.

(ii) To construe and interpret the Plan, Awards granted under it, Option Agreements and Award Agreements, and to establish, amend and revoke rules and regulations for their administration. The Board, in the exercise of this power, may correct any defect, omission or inconsistency in the Plan or in any Option Agreement or Award Agreement, in a manner and to the extent it shall deem necessary or expedient to make the Plan fully effective.

(iii) To amend the Plan, an Award, an Award Agreement or an Option Agreement as provided in Section 12, provided that, the Board shall not amend the Fair Market Value of an Award or extend the term of an Option or Award without obtaining the approval of the stockholders if required by the rules of any stock exchange upon which the Common Stock is listed.

(iv) To reprice any Options granted under the Plan by lowering the exercise price of an Option after it is granted, canceling an Option at a time when its exercise price exceeds the Fair Market Value of the stock underlying the Option, in exchange for another Option or Award, as well as any other action that is treated as a repricing under generally accepted accounting principles.

(v) Generally, to exercise such powers and to perform such acts as the Board deems necessary or expedient to promote the best interests of the Company which are not in conflict with the provisions of the Plan.

(c) Delegation to Committee.

(i) General. The Board may delegate administration of the Plan and its powers and duties thereunder to a Committee or Committees, and the term "Committee" shall apply to any person or persons to whom such authority has been delegated. Upon such delegation, the Committee shall have the powers theretofore possessed by the Board, including the power to delegate to a subcommittee any of the administrative powers the Committee is authorized to exercise (and references in this Plan to the Board shall thereafter be deemed to include the Committee or subcommittee), subject, however, to such resolutions, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. In its absolute discretion, the Board may at any time and from time to time exercise any and all rights and duties of the Committee under this Plan, except respecting matters under Rule 16b-3 of the Exchange Act or Section 162(m) of the Code, or any rules or regulations issued thereunder, which are required to be determined in the sole discretion of the Committee.

(ii) Committee Composition. A Committee shall consist solely of two (2) or more Independent Directors. Within the scope of its authority, the Board or the Committee may (1) delegate to a committee of one or more members of the Board who are not Independent Directors the authority to grant Awards to eligible persons who are either (a) not then Covered Employees and are not expected to be Covered Employees at the time of recognition of income resulting from such Award or (b) not persons with respect to whom the Company wishes to comply with Section 162(m) of the

Code, and/or (2) delegate to a committee of one or more members of the Board who are not Independent Directors or to the Company's Chief Executive Officer the authority to grant Awards to eligible persons who are not then subject to Section 16 of the Exchange Act.

(d) Effect of Board's Decision; No Liability. All determinations, interpretations and constructions made by the Board in good faith shall not be subject to review by any person and shall be final, binding and conclusive on all persons. No member of the Board or the Committee or any person to whom duties hereunder have been delegated shall be liable for any action, interpretation or determination made in good faith, and such persons shall be entitled to full indemnification and reimbursement consistent with applicable law and in the manner provided in the Company's Articles of Incorporation and Bylaws, as the same may be amended from time to time, or as otherwise provided in any agreement between any such member and the Company.

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4. Stock Subject to the Plan.

(a) Stock Reserve. Subject to the provisions of Section 11 relating to adjustments upon changes in Common Stock, the shares of Common Stock that may be issued pursuant to Awards shall not exceed in the aggregate three hundred thousand (300,000) shares of Common Stock.

(b) Reversion of Stock to the Stock Reserve. If any Award shall for any reason expire or otherwise terminate, in whole or in part, without having been exercised in full, the shares of Common Stock not acquired under such Award shall revert to and again become available for issuance under the Plan.

(c) Source of Stock. The Common Stock subject to the Plan may be unissued stock or reacquired stock, bought on the market or otherwise.

5. Eligibility.

(a) Eligibility for Specific Awards. Incentive Stock Options may be granted only to Employees. Awards other than Incentive Stock Options may be granted to Employees and Directors.

(b) Ten Percent Stockholders. A Ten Percent Stockholder shall not be granted an Incentive Stock Option unless the exercise price of such Option is at least one hundred ten percent (110%) of the Fair Market Value of the Common Stock at the date of grant and the Option is not exercisable after the expiration of five (5) years from the date of grant.

6. Option Provisions.

Each Option Agreement shall be subject to the terms and conditions of this Plan. Each Option and Option Agreement shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. All Options shall be separately designated Incentive Stock Options or Nonqualified Stock Options at the time of grant, and, if certificates are issued, a separate certificate or certificates will be issued for the shares of Common Stock purchased on exercise of each type of Option. The provisions of separate Options need not be identical.

(a) Provisions Applicable to All Options.

(i) Consideration. The purchase price of the shares of Common Stock acquired pursuant to an Option shall be paid as follows: (a) in cash or by certified or official bank check, payable to the order of the Company, in the amount (the "Purchase Price") equal to the exercise price of the Option multiplied by the number of shares plus payment of all taxes applicable upon such exercise; (b) with shares owned by the Optionholder having a Fair Market Value at the time the Option is exercised equal to the Purchase Price plus payment in cash of all taxes applicable upon such exercise, with the prior approval of the Board; (c) by surrendering to the Company the right to acquire a number of shares having an aggregate value such that the amount by which the Fair Market Value of such shares exceeds the aggregate exercise price is equal to the Purchase Price plus payment in cash of all taxes applicable upon such exercise, with the prior approval of the Board; (d) any combination of the foregoing; or (e) a manner acceptable to the Board.

(ii) Vesting Generally. An Option may (A) vest, and therefore become exercisable, in periodic installments that may, but need not, be equal, or (B) be fully vested at the time of grant. The Option may be subject to such other terms and conditions on the time or times when it may be exercised (which may be based on performance or other criteria) as the Board may deem appropriate. The vesting provisions, if any, of individual Options may vary. The provisions of this subsection 6(a)(ii) are subject to any Option Agreement provisions governing the minimum number of Common Stock as to which an Option may be exercised.

(iii) <u>Termination of Continuous Service</u>. Unless otherwise provided in the Option Agreement, in the event an Optionholder's Continuous Service terminates (other than upon the Optionholder's death, Disability, retirement or as a result of a Change of Control), all Options held by the Optionholder shall immediately terminate; *provided*, *however*, that an Option Agreement may provide that if an Optionholder's Continuous Service is terminated for reasons other than for cause, all vested Options held by such person shall continue to be exercisable until the earlier of the expiration date of such Option or ninety (90) days after the date of such termination. All such vested Options not exercised within the period described in the preceding sentence shall terminate.

(iv) <u>Disability or Death of Optionholder</u>. Unless otherwise provided in the Option Agreement, in the event of an Optionholder's Disability or death, all unvested Options shall immediately terminate, and all vested Options held by such person shall continue to be exercisable for twelve months after the date of such Disability or death. All such vested Options not exercised within such twelve-month period shall terminate.

(v) <u>Retirement</u>. Unless otherwise provided in the Option Agreement, in the event of the Optionholder's retirement, all unvested Options shall automatically vest on the date of such retirement and all Options shall be exercisable for the earlier of twelve (12) months after such retirement date or the expiration date of such Options. All such Options not exercised within the period described in the preceding sentence shall terminate.

(b) <u>Provisions Applicable to Incentive Stock Options</u>.

(i) <u>Term</u>. Subject to the provisions of subsection 5(b) regarding Ten Percent Stockholders, no Incentive Stock Option shall be exercisable after the expiration of ten (10) years from the date it was granted. Further, no grant of an Incentive Stock Option shall be made under this Plan more than ten (10) years after the date the Plan is approved by the stockholders of the Company.

(ii) <u>Exercise Price of an Incentive Stock Option</u>. Subject to the provisions of subsection 5(b) regarding Ten Percent Stockholders, the exercise price of each Incentive Stock Option shall be not less than one hundred percent (100%) of the Fair Market Value of the Common Stock subject to the Option on the date the Option is granted.

(iii) <u>Transferability of an Incentive Stock Option</u>. An Incentive Stock Option shall not be transferable except by will or by the laws of descent and distribution and shall be exercisable during the lifetime of the Optionholder only by the Optionholder.

(iv) Incentive Stock Option $100,000 Limitation. Notwithstanding any other provision of the Plan or an Option Agreement, the aggregate Fair Market Value of the Common Stock with respect to which Incentive Stock Options are exercisable for the first time by an Optionholder in any calendar year, under the Plan or any other option plan of the Company or its Affiliates, shall not exceed One Hundred Thousand Dollars ($100,000). For this purpose, the Fair Market Value of the Common Stock shall be determined as of the time an Option is granted. The Options or portions thereof which exceed such limit (according to the order in which they were granted) shall be treated as Nonqualified Stock Options.

(c) Provisions Applicable to Nonqualified Stock Options.

(i) Exercise Price of a Nonqualified Stock Option. The exercise price of each Nonqualified Stock Option shall be not less than one hundred percent (100%) of the Fair Market Value of the Common Stock subject to the Option on the date the Option is granted.

(ii) Transferability of a Nonqualified Stock Option. A Nonqualified Stock Option shall be transferable, if at all, to the extent provided in the Option Agreement. If the Option Agreement does not provide for transferability, then the Nonqualified Stock Option shall not be transferable except by will or by the laws of descent and distribution and shall be exercisable during the lifetime of the Optionholder only by the Optionholder.

7. Provisions of Awards Other than Options.

(a) Restricted Stock Awards. Each restricted stock Award agreement shall be in such form and shall contain such restrictions, terms and conditions, if any, as the Board shall deem appropriate and shall be subject to the terms and conditions of this Plan. The terms and conditions of restricted stock Award Agreements may change from time to time, and the terms and conditions of separate restricted stock Award Agreements need not be identical, but each restricted stock Award Agreement shall include (through incorporation of provisions hereof by reference in the agreement or otherwise) the substance of each of the following provisions:

(i) Consideration. A restricted stock Award may be awarded in consideration for past services actually rendered, or for future services to be rendered, to the Company or an Affiliate for its benefit.

(ii) Vesting. Common Stock awarded under the restricted stock Award Agreement may (A) be subject to a vesting schedule to be determined by the Board or (B) be fully vested at the time of grant.

(iii) Termination of Participant’s Continuous Service. Unless otherwise provided in the restricted stock Award Agreement, in the event a Participant’s Continuous Service terminates prior to a vesting date set forth in the restricted stock Award Agreement, any unvested restricted stock Award shall be forfeited and automatically transferred to and reacquired by the Company at no cost to the Company, and neither the Participant nor his or her heirs, executors, administrators or successors shall have any right or interest in the restricted stock Award. Notwithstanding the foregoing, unless otherwise provided in the restricted stock Award agreement, in the event a Participant’s Continuous Service terminates as a result of (A) being terminated by the Company for reasons other than for cause, (B) death, (C) Disability, (D) retirement, or (E) a Change of Control (subject to the provisions of Section 11(c) hereof), then any unvested restricted stock Award shall vest immediately upon such date.

(iv) Transferability. Rights to acquire Common Stock under the restricted stock Award Agreement shall be transferable by the Participant only upon such terms and conditions as are set forth in the restricted stock Award Agreement, as the Board shall determine in its discretion, so long as Common Stock awarded under the restricted stock Award Agreement remain subject to the terms of the restricted stock Award Agreement.

(b) <u>Grant of Stock Appreciation Rights</u>. Stock appreciation rights to receive in shares of Common Stock the excess of the Fair Market Value of Common Stock on the date the rights are surrendered over the Fair Market Value of Common Stock on the date of grant may be granted to any Employee or Director selected by the Board. A stock appreciation right may be granted (i) in connection and simultaneously with the grant of another Award, (ii) with respect to a previously granted Award, or (iii) independent of another Award. A stock appreciation right shall be subject to such terms and conditions not inconsistent with this Plan as the Board shall impose and shall be evidenced by a written stock appreciation right agreement, which shall be executed by the Participant and an authorized officer of the Company. The Board, in its discretion, may determine whether a stock appreciation right is to qualify as performance-based compensation as described in Section 162(m)(4)(C) of the Code and stock appreciation right agreements evidencing stock appreciation rights intended to so qualify shall contain such terms and conditions as may be necessary to meet the applicable provisions of Section 162(m) of the Code. The Board may, in its discretion and on such terms as it deems appropriate, require as a condition of the grant of a stock appreciation right that the Participant surrender for cancellation some or all of the Awards previously granted to such person under this Plan or otherwise. A stock appreciation right, the grant of which is conditioned upon such surrender, may have an exercise price lower (or higher) than the exercise price of the surrendered Award, may contain such other terms as the Board deems appropriate, and shall be exercisable in accordance with its terms, without regard to the number of shares, price, exercise period or any other term or condition of such surrendered Award.

8. <u>Availability of Stock</u>.

Subject to the restrictions set forth in Section 4(a), during the terms of the Awards, the Company shall keep available at all times the number of shares of Common Stock required to satisfy such Awards.

9. <u>Use of Proceeds from Stock</u>.

Proceeds from the sale of Common Stock pursuant to Awards shall constitute general funds of the Company.

10. <u>Miscellaneous</u>.

(a) <u>Exercise of Awards</u>. Awards shall be exercisable at such times, or upon the occurrence of such event or events as the Board shall determine at or subsequent to grant. Awards may be exercised in whole or in part. Common Stock purchased upon the exercise of an Award shall be paid for in full at the time of such purchase.

(b) <u>Acceleration of Exercisability and Vesting</u>. The Board shall have the power to accelerate the time at which an Award may first be exercised or the time during which an Award or any part thereof will vest in accordance with the Plan, notwithstanding the provisions in the Award stating the time at which it may first be exercised or the time during which it will vest.

(c) Stockholder Rights.

(i) Options. Unless otherwise provided in and upon the terms and conditions in the Option Agreement, no Participant shall be deemed to be the holder of, or to have any of the rights of a holder with respect to, any Common Stock subject to an Option unless and until such Participant has satisfied all requirements for exercise of, and has exercised, the Option pursuant to its terms.

(ii) Restricted Stock. Unless otherwise provided in and upon the terms and conditions in the restricted stock Award Agreement, a Participant shall have the right to receive all dividends and other distributions paid or made respecting such restricted stock, provided, however, no unvested restricted stock shall have any voting rights of a stockholder respecting such unvested restricted stock unless and until such unvested restricted stock become vested.

(d) No Employment or other Service Rights. Nothing in the Plan or any instrument executed or Award granted pursuant thereto shall confer upon any Participant any right to continue to serve the Company or an Affiliate in the capacity in effect at the time the Award was granted, or any other capacity, or shall affect the right of the Company or an Affiliate to terminate with or without notice and with or without cause (i) the employment of an Employee or an Affiliate or (ii) the service of a Director of the Company or an Affiliate.

(e) Withholding Obligations. If the Company has or will have a legal obligation to withhold the taxes related to the grant, vesting or exercise of the Award, such Award may not be granted, vested or exercised in whole or in part, unless such tax obligation is first satisfied in a manner satisfactory to the Company. To the extent provided by the terms of an Award Agreement or Option Agreement, the Participant may satisfy any federal, state or local tax withholding obligation relating to the exercise or acquisition of Common Stock under an Award by any of the following means (in addition to the Company's right to withhold from any compensation paid to the Participant by the Company) or by a combination of such means: (i) tendering a cash payment in Dollars; (ii) authorizing the Company to withhold Common Stock from the Common Stock otherwise issuable to the Participant as a result of the exercise or acquisition of Common Stock under the Award, provided, however, that no shares of Common Stock are withheld with a value exceeding the minimum amount of tax required to be withheld by law; or (iii) delivering to the Company owned and unencumbered Common Stock.

(f) Listing and Qualification of Stock. This Plan and the grant and exercise of Awards hereunder, and the obligation of the Company to sell and deliver Common Stock under such Awards, shall be subject to all applicable United States federal and state laws, rules and regulations, and any other laws applicable to the Company, and to such approvals by any government or regulatory agency as may be required. The Company, in its discretion, may postpone the issuance or delivery of Common Stock upon any exercise of an Award until completion of any stock exchange listing, or the receipt of any required approval from any stock exchange or other qualification of such Common Stock under any United States federal or state law rule or regulation as the Company may consider appropriate, and may require any individual to whom an Award is granted, such individual's beneficiary or legal representative, as applicable, to make such representations and furnish such information as the Board may consider necessary, desirable or advisable in connection with the issuance or delivery of the Common Stock in compliance with applicable laws, rules and regulations.

(g) Non-Uniform Determinations. The Board's determinations under this Plan (including, without limitation, determinations of the persons to receive Awards, the form, term, provisions, amount and timing of the grant of such Awards and of the agreements evidencing the same) need not be uniform and may be made by it selectively among persons who receive, or are eligible to receive, Awards under this Plan, whether or not such persons are similarly situated.

11. Adjustments Upon Changes in Stock.

(a) Capitalization Adjustments. If any change is made in the Common Stock subject to the Plan, or subject to any Award, without the receipt of consideration by the Company (through merger, consolidation, reorganization, recapitalization, reincorporation, stock dividend, dividend in property other than cash, stock split, liquidating dividend, combination of stock, exchange of stock, change in corporate structure or other transaction), the Plan will be appropriately adjusted in the class(es) and maximum number of securities subject to the Plan pursuant to subsection 4(a) and the maximum number of securities subject to award to any person pursuant to subsection 5(c), and the outstanding Awards will be appropriately adjusted in the class(es) and number of securities and price per stock of Common Stock subject to such outstanding Awards. The Board shall make such adjustments, and its determination shall be final, binding and conclusive. (The conversion of any convertible securities of the Company shall not be treated as a transaction “without receipt of consideration” by the Company.)

(b) **<u>Dissolution or Liquidation</u>.** In the event of a dissolution or liquidation of the Company, then all outstanding Awards shall terminate immediately prior to such event.

(c) **<u>Asset Sale, Merger, Consolidation or Reverse Merger</u>.** In the event of a Change of Control (as defined below), any unvested Awards shall vest immediately prior to the closing of the Change of Control, and the Board shall have the power and discretion to provide for the Participant's election alternatives regarding the terms and conditions for the exercise of, or modification of, any outstanding Awards granted hereunder, provided, however, such alternatives shall not affect the then current exercise provisions without such Participant's consent. The Board may provide that Awards granted hereunder must be exercised in connection with the closing of such transaction, and that if not so exercised such Awards will expire. Any such determinations by the Board may be made generally with respect to all Participants, or may be made on a case-by-case basis with respect to particular Participants. For the purpose of this Plan, a "Change of Control" shall have occurred in the event one or more persons acting individually or as a group (i) acquires sufficient additional stock to constitute more than fifty percent (50%) of (A) the total Fair Market Value of all Common Stock issued and outstanding or (B) the total voting power of all shares of capital stock authorized to vote for the election of directors; (ii) acquires, in a twelve (12) month period, thirty-five percent (35%) or more of the voting power of all shares of capital stock authorized to vote for the election of directors, or alternatively a majority of the members of the board is replaced during any twelve (12) month period by directors whose appointment was not endorsed by a majority of the members of the board; or (iii) acquires, during a twelve (12) month period, more than forty percent (40%) of the total gross fair market value of all of the Company's assets. Notwithstanding the foregoing, the provisions of this Section 11(c) shall not apply to (i) any transaction involving any stockholder that individually or as a group owns more than fifty percent (50%) of the outstanding Common Stock on the date this Plan is approved by the Company's stockholders, until such time as such stockholder first owns less than forty percent (40%) of the total outstanding Common Stock, or (ii) any transaction undertaken for the purpose of reincorporating the Company under the laws of another jurisdiction, if such transaction does not materially affect the beneficial ownership of the Company's capital stock.

12. <u>Amendment of the Plan and Awards</u>.

(a) **<u>Amendment of Plan</u>.** The Board at any time, and from time to time, may amend the Plan. However, except as provided in Section 11 relating to adjustments upon changes in Common Stock, no amendment shall be effective unless approved by the stockholders of the Company to the extent stockholder approval is necessary to satisfy the requirements of Section 422 of the Code, Rule 16b-3 or any applicable Nasdaq or securities exchange listing requirements.

(b) **<u>Stockholder Approval</u>.** The Board may, in its sole discretion, submit any other amendment to the Plan for stockholder approval, including, but not limited to, amendments to the Plan intended to satisfy the requirements of Section 162(m) of the Code and the regulations thereunder regarding the exclusion of performance-based compensation from the limit on corporate deductibility of compensation paid to certain executive officers.

(c) Contemplated Amendments. It is expressly contemplated that the Board may amend the Plan in any respect the Board deems necessary or advisable to provide eligible Employees with the maximum benefits provided or to be provided under the provisions of the Code and the regulations promulgated thereunder relating to Incentive Stock Options and/or to bring the Plan and/or Incentive Stock Options granted under it into compliance therewith.

(d) No Impairment of Rights. Rights under any Award granted before amendment of the Plan shall not be impaired by any amendment of the Plan unless the Participant consents in writing.

(e) <u>Amendment of Awards</u>. Subject to Section 3(b)(iii), the Board at any time, and from time to time, may amend the terms of any one or more Awards; provided, however, that the rights under any Award shall not be impaired by any such amendment unless the applicable Participant consents in writing.

13. <u>Termination or Suspension of the Plan</u>.

(a) <u>Plan Term</u>. The Board may suspend or terminate the Plan at any time. Unless sooner terminated, the Plan shall terminate on the day before the tenth (10th) anniversary of the date the Plan is adopted by the stockholders of the Company. No Awards may be granted under the Plan while the Plan is suspended or after it is terminated.

(b) <u>No Impairment of Rights</u>. Suspension or termination of the Plan shall not impair rights and obligations under any Award granted while the Plan is in effect except with the written consent of the Participant.

(c) <u>Savings Clause</u>. This Plan is intended to comply in all aspects with applicable laws and regulations. In case any one or more of the provisions of this Plan shall be held invalid, illegal or unenforceable in any respect under applicable law or regulation, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby and the invalid, illegal or unenforceable provision shall be deemed null and void; however, to the extent permissible by law, any provision which could be deemed null and void shall first be construed, interpreted or revised retroactively to permit this Plan to be construed in compliance with all applicable laws so as to foster the intent of this Plan.

14. <u>Effective Date of Plan</u>.

The Plan shall become effective as determined by the Board, but no Award shall be exercised (or, in the case of a restricted stock Award, shall be granted) unless and until the Plan has been approved by the stockholders of the Company, which approval shall be within twelve (12) months before or after the date the Plan is adopted by the Board.

15. <u>Choice of Law</u>.

The law of the state of Nevada shall govern all questions concerning the construction, validity and interpretation of this Plan, without regard to such state’s conflict of laws rules.

(The Plan was adopted by the Board of Directors on March 27, 2015).

Admission Ticket

Bring this ticket with you for admission to the 2015 Annual Meeting

Digital Ally, Inc.

2015 Annual Meeting of Stockholders

Tuesday, June 9, 2015 at 10:00 a.m. CDT

9705 Loiret Boulevard

Lenexa, Kansas 66219

Your vote is important

FOLD AND DETACH HERE AND READ THE REVERSE SIDE

DIGITAL ALLY, INC.

THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS

FOR THE 2015 ANNUAL MEETING

OF STOCKHOLDERS TO BE HELD

ON TUESDAY, JUNE 9, 2015

The undersigned hereby appoints **Thomas J. Heckman** and **Christa Johnson**, and each of them as the true and lawful attorney, agent and proxy of the undersigned, with full power of substitution, to represent and to vote all shares of common stock of **Digital Ally, Inc.** held of record by the undersigned on April 27, 2015, at the 2015 Annual Meeting of Stockholders to be held at the corporate facility located at 9705 Loiret Boulevard, Lenexa, Kansas 66219, on Tuesday, June 9, 2015 at 10:00 a.m., CDT, and at any adjournments thereof.

Any and all proxies heretofore given are hereby revoked.

When properly executed, this proxy will be voted as designated by the undersigned.

If no choice is specified, the proxy will be voted, in relation to Proposal 4, **FOR** the ratification of the appointment of McGladrey LLP as our independent registered public accounting firm.

In his or her discretion, the proxy is authorized to vote upon such other business that may properly come before the annual meeting.

(Continued and to be dated and signed on reverse side)

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2015 ANNUAL MEETING OF STOCKHOLDERS OF DIGITAL ALLY, INC.

Tuesday, June 9, 2015

Please date, sign and mail your proxy card in the envelope provided as soon as possible. Please mark your vote in blue or black ink. Please detach along perforated line and mail in the envelope provided.

The Board of Directors recommends that you vote as follows: “FOR” the election of the four nominees to the Board of Directors; “FOR” Proposals 2, 3 and 4.

Proposal 1: Election of Directors of the Company

NOMINEES

[ ] FOR ALL NOMINEES

[ ] Stanton E. Ross

[ ] Leroy C. Richie

[ ] Daniel F. Hutchins

[ ] Elliot M. Kaplan

[ ] WITHHOLD AUTHORITY FOR ALL NOMINEES

[ ] FOR ALL EXCEPT ___________________________________

(See instructions below)

INSTRUCTIONS: To withhold authority to vote for any individual nominee(s), mark **“FOR ALL EXCEPT”** and fill in the circle next to each nominee you wish to withhold, as shown here: [ ]

To change the address on your account, please check the box at right and indicate your new address in the address space above. Please note that changes to the registered name(s) on the account may not be submitted via this method. [ ]

Proposal 2. FOR the amendment to our Articles of Incorporation to increase the number of authorized shares of our capital stock that we may issue from 9,375,000 to 25,000,000, of which all 25,000,000 shares shall be classified as common stock:

FOR	AGAINST	ABSTAIN
[ ]	[ ]	[ ]

Proposal 3. FOR approval of the 2015 Digital Ally, Inc. Stock Option and Restricted Stock Plan and to reserve 300,000 shares for issuance under the Plan:

FOR	AGAINST	ABSTAIN
[ ]	[ ]	[ ]

Proposal 4. FOR ratification of the appointment of McGladrey LLP as our independent registered public accounting firm:

FOR	AGAINST	ABSTAIN
[ ]	[ ]	[ ]

In his discretion, the proxy is authorized to vote upon such other business that may properly come before the 2015 Annual Meeting.

Signature of Stockholder Date Signature of Date Stockholder

NOTE:	Please sign exactly as name appears below. When shares are held by joint tenants, both should sign. When signing as attorney, as executor, administrator, trustee or guardian, please give full title as such. If a corporation, please sign in full corporate name by President or other authorized officer. If a partnership, please sign in partnership name by authorized person.

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