AUBURN NATIONAL BANCORPORATION, INC
Form 10-Q
October 31, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended September 30, 2014

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period ________ to ________

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**63-0885779**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 N. Gay Street

Auburn, Alabama 36830

(334) 821-9200

(Address and telephone number of principal executive offices)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

Large Accelerated filer ¨	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

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

Class	Outstanding at October 31, 2014
Common Stock, $0.01 par value per share	3,643,328 shares

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

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PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Unaudited)

(Dollars in thousands, except share data)	September 30, 2014	December 31, 2013
Assets:		
Cash and due from banks	$ 13,118	$ 13,437
Federal funds sold	57,970	26,965
Interest bearing bank deposits	12,178	13,820
Cash and cash equivalents	83,266	54,222
Securities available-for-sale	264,827	271,219
Loans held for sale	3,521	2,296
Loans, net of unearned income	394,602	383,339
Allowance for loan losses	(4,754)	(5,268)
Loans, net	389,848	378,071
Premises and equipment, net	10,175	10,442
Bank-owned life insurance	17,878	17,503
Other real estate owned	1,215	3,884
Other assets	10,406	13,706
Total assets	$ 781,136	$ 751,343
Liabilities:		
Deposits:		
Noninterest-bearing	$ 127,472	$ 125,740
Interest-bearing	553,291	543,104
Total deposits	680,763	668,844
Federal funds purchased and securities sold under agreements to repurchase	4,334	3,363
Long-term debt	12,217	12,217
Accrued expenses and other liabilities	10,629	2,434
Total liabilities	707,943	686,858
Stockholders equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; no issued shares		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,763	3,759
Retained earnings	75,080	71,879
Accumulated other comprehensive income (loss), net	950	(4,552)
	(6,639)	(6,640)

Less treasury stock, at cost - 313,807 shares and 314,017 shares at September 30, 2014 and December 31, 2013, respectively				
Total stockholders equity		73,193		64,485
Total liabilities and stockholders equity	$	781,136	$	751,343

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

(In thousands, except share and per share data)	Quarter ended September 30, 2014	Quarter ended September 30, 2013	Nine months ended September 30, 2014	Nine months ended September 30, 2013
Interest income:				
Loans, including fees	$ 4,953	$ 5,104	$ 14,509	$ 15,656
Securities:				
Taxable	1,171	1,030	3,561	2,803
Tax-exempt	622	683	1,856	2,133
Federal funds sold and interest bearing bank deposits	33	39	105	99
Total interest income	6,779	6,856	20,031	20,691
Interest expense:				
Deposits	1,221	1,344	3,733	4,097
Short-term borrowings	5	3	14	10
Long-term debt	105	239	313	941
Total interest expense	1,331	1,586	4,060	5,048
Net interest income	5,448	5,270	15,971	15,643
Provision for loan losses	300		(100)	400
Net interest income after provision for loan losses	5,148	5,270	16,071	15,243
Noninterest income:				
Service charges on deposit accounts	228	224	660	707
Mortgage lending	534	750	1,268	2,397
Bank-owned life insurance	124	93	375	289
Other	366	365	1,081	1,086
Securities (losses) gains, net:				
Realized (losses) gains, net	(235)		(197)	679
Total other-than-temporary impairments			(333)	
Total securities (losses) gains, net	(235)		(530)	679
Total noninterest income	1,017	1,432	2,854	5,158
Noninterest expense:				
Salaries and benefits	2,199	2,139	6,701	6,503
Net occupancy and equipment	346	346	1,039	1,010
Professional fees	204	197	635	582
FDIC and other regulatory assessments	125	130	399	467
Other real estate owned, net	(237)	68	(181)	111
Prepayment penalties on long-term debt		541		2,012
Other	947	853	2,731	2,539
Total noninterest expense	3,584	4,274	11,324	13,224

Earnings before income taxes	2,581	2,428	7,601	7,177
Income tax expense	709	636	2,049	1,789
Net earnings	$ 1,872	$ 1,792	$ 5,552	$ 5,388
Net earnings per share:				
Basic and diluted	$ 0.51	$ 0.49	$ 1.52	$ 1.48
Weighted average shares outstanding:				
Basic and diluted	3,643,328	3,643,028	3,643,262	3,642,967

See accompanying notes to consolidated financial statements

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)	Quarter ended September 30, 2014	Quarter ended September 30, 2013	Nine months ended September 30, 2014	Nine months ended September 30, 2013
Net earnings	$ 1,872	$ 1,792	$ 5,552	$ 5,388
Other comprehensive (loss) income, net of tax:				
Unrealized net holding (loss) gain on securities	(335)	(433)	5,167	(7,010)
Reclassification adjustment for net loss (gain) on securities recognized in net earnings	149		335	(428)
Other comprehensive (loss) income	(186)	(433)	5,502	(7,438)
Comprehensive income (loss)	$ 1,686	$ 1,359	$ 11,054	$ (2,050)

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Unaudited)

(Dollars in thousands, except share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive (loss) income	Treasury stock	Total
Balance, December 31, 2012	3,957,135	$ 39	$ 3,756	$ 67,821	$ 5,174	$ (6,641)	$ 70,149
Net earnings				5,388			5,388
Other comprehensive loss					(7,438)		(7,438)
Cash dividends paid ($0.63 per share)				(2,294)			(2,294)
Sale of treasury stock (155 shares)			2				2
Balance, September 30, 2013	3,957,135	$ 39	$ 3,758	$ 70,915	$ (2,264)	$ (6,641)	$ 65,807
Balance, December 31, 2013	3,957,135	$ 39	$ 3,759	$ 71,879	$ (4,552)	$ (6,640)	$ 64,485
Net earnings				5,552			5,552
Other comprehensive income					5,502		5,502
Cash dividends paid ($0.645 per share)				(2,351)			(2,351)
Sale of treasury stock (210 shares)			4			1	5
Balance, September 30, 2014	3,957,135	$ 39	$ 3,763	$ 75,080	$ 950	$ (6,639)	$ 73,193

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Nine months ended September 30, 2014	2013
Cash flows from operating activities:		
Net earnings	$ 5,552	$ 5,388
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	(100)	400
Depreciation and amortization	557	639
Premium amortization and discount accretion, net	1,150	1,620
Net loss (gain) on securities available-for-sale	530	(679)
Net gain on sale of loans held for sale	(880)	(1,693)
Increase (decrease) in MSR valuation allowance	31	(373)
Net (gain) loss on other real estate owned	(204)	13
Loss on prepayment of long-term debt		2,012
Loans originated for sale	(44,185)	(80,169)
Proceeds from sale of loans	43,469	81,689
Increase in cash surrender value of bank owned life insurance	(375)	(289)
Net (increase) decrease in other assets	(82)	2,392
Net increase in accrued expenses and other liabilities	8,200	455
Net cash provided by operating activities	13,663	11,405
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	37,132	38,614
Proceeds from maturities of securities available-for-sale	47,241	48,588
Purchase of securities available-for-sale	(70,943)	(99,923)
(Increase) decrease in loans, net	(12,126)	14,033
Net purchases of premises and equipment	(19)	(516)
Decrease in FHLB stock	235	1,153
Proceeds from sale of other real estate owned	3,322	2,599
Net cash provided by investing activities	4,842	4,548
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	1,732	951
Net increase in interest-bearing deposits	10,187	12,653
Net increase in federal funds purchased and securities sold under agreements to repurchase	971	54
Repayments or retirement of long-term debt		(27,012)
Dividends paid	(2,351)	(2,294)
Net cash provided by (used in) financing activities	10,539	(15,648)
Net change in cash and cash equivalents	29,044	305
Cash and cash equivalents at beginning of period	54,222	61,949
Cash and cash equivalents at end of period	$ 83,266	$ 62,254

Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 4,125	$ 5,228
Income taxes	963	258
Supplemental disclosure of non-cash transactions:		
Real estate acquired through foreclosure	449	2,278

See accompanying notes to consolidated financial statements

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

Auburn National Bancorporation, Inc. (the Company) provides a full range of banking services to individual and corporate customers in Lee County, Alabama and surrounding counties through its wholly owned subsidiary, AuburnBank (the Bank). The Company does not have any segments other than banking that are considered material.

Basis of Presentation and Use of Estimates

The unaudited consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The unaudited consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company s annual report on Form 10-K for the year ended December 31, 2013.

The unaudited consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Auburn National Bancorporation Capital Trust I is an affiliate of the Company and was included in these unaudited consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include other-than-temporary impairment on investment securities, the determination of the allowance for loan losses, fair value of financial instruments, and the valuation of deferred tax assets and other real estate owned.

Reclassifications

Certain amounts reported in prior periods have been reclassified to conform to the current-period presentation. These reclassifications had no impact on the Company s previously reported net earnings or total stockholders equity.

Subsequent Events

The Company has evaluated the effects of events and transactions through the date of this filing that have occurred subsequent to September 30, 2014. The Company does not believe there were any material subsequent events during this period that would have required further recognition or disclosure in the unaudited consolidated financial statements included in this report.

Accounting Developments

In the first quarter of 2014, the Company adopted new guidance related to the following Accounting Standards Update (Update or ASU):

ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.*

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Information about this pronouncement is described in more detail below.

ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists,* is expected to eliminate diversity in practice as it provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward exists. The changes were effective for the Company during the first quarter of 2014. Adoption of this ASU had no impact on the financial statements of the Company.

NOTE 2: BASIC AND DILUTED EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the respective period. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company s common stock. At September 30, 2014 and 2013, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

The basic and diluted earnings per share computations for the respective periods are presented below.

	Quarter ended September 30,		Nine months ended September 30,	
(In thousands, except share and per share data)	2014	2013	2014	2013
Basic and diluted:				
Net earnings	$ 1,872	$ 1,792	$ 5,552	$ 5,388
Weighted average common shares outstanding	3,643,328	3,643,028	3,643,262	3,642,967
Earnings per share	$ 0.51	$ 0.49	$ 1.52	$ 1.48

NOTE 3: VARIABLE INTEREST ENTITIES

Generally, a variable interest entity (VIE) is a corporation, partnership, trust or other legal structure that does not have equity investors with substantive or proportional voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities.

At September 30, 2014, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, discussed below.

Trust Preferred Securities

The Company owns the common stock of a subsidiary business trust, Auburn National Bancorporation Capital Trust I, which issued mandatorily redeemable preferred capital securities (trust preferred securities) in the aggregate of approximately $7.0 million at the time of issuance. This trust meets the definition of a VIE of which the Company is not the primary beneficiary; the trust s only assets are junior subordinated debentures issued by the Company, which were acquired by the trust using the proceeds from the issuance of the trust preferred securities and common stock. The junior subordinated debentures of approximately $7.2 million are included in long-term debt and the Company s equity interest of $0.2 million in the business trust is included in other assets. Interest expense on the junior subordinated debentures is included in interest expense on long-term debt.

The following table summarizes VIEs that are not consolidated by the Company as of September 30, 2014.

(Dollars in thousands)	Maximum Loss Exposure	Liability Recognized	Classification
Type:			
Trust preferred issuances	N/A	$ 7,217	Long-term debt

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NOTE 4: SECURITIES

At September 30, 2014 and December 31, 2013, respectively, all securities within the scope of ASC 320, *Investments Debt and Equity Securities,* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at September 30, 2014 and December 31, 2013, respectively, are presented below.

(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
September 30, 2014								
Agency obligations (a)	$	25,753	19,682	14,068	59,503	146	1,373	$ 60,730
Agency RMBS (a)			6,958	132,226	139,184	1,064	1,545	139,665
State and political subdivisions		507	16,197	49,436	66,140	3,217	5	62,928
Total available-for-sale	$	26,260	42,837	195,730	264,827	4,427	2,923	$ 263,323
December 31, 2013								
Agency obligations (a)	$		23,247	21,275	44,522		4,557	$ 49,079
Agency RMBS (a)			8,306	154,052	162,358	976	4,733	166,115
State and political subdivisions		1,735	21,366	41,238	64,339	1,560	459	63,238
Total available-for-sale	$	1,735	52,919	216,565	271,219	2,536	9,749	$ 278,432

(a) Includes securities issued by U.S. government agencies or government sponsored entities.

Securities with aggregate fair values of $119.7 million and $120.5 million at September 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets are cost-method investments. The carrying amounts of cost-method investments were $1.6 million and $1.8 million at September 30, 2014 and December 31, 2013, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (FRB) stock.

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at September 30, 2014 and December 31, 2013, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer, are presented below.

	Less than 12 Months		12 Months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2014:						
Agency obligations	$ 17,494	28	23,609	1,345	$ 41,103	1,373
Agency RMBS	25,730	62	52,358	1,483	78,088	1,545
State and political subdivisions	670	4	769	1	1,439	5
Total	$ 43,894	94	76,736	2,829	$ 120,630	2,923

December 31, 2013:								
Agency obligations	$	35,933	3,182	8,590	1,376	$	44,523	4,558
Agency RMBS		109,774	4,393	7,683	339		117,457	4,732
State and political subdivisions		9,575	459				9,575	459
Total	$	155,282	8,034	16,273	1,715	$	171,555	9,749

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For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. On a quarterly basis, the Company assesses each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

In determining whether a loss is temporary, the Company considers all relevant information including:

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);
- the historical and implied volatility of the fair value of the security;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency; and
- recoveries or additional declines in fair value subsequent to the balance sheet date.

Agency obligations

The unrealized losses associated with agency obligations were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Agency RMBS

The unrealized losses associated with agency residential mortgage-backed securities (RMBS) were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Securities of U.S. states and political subdivisions

The unrealized losses associated with securities of U.S. states and political subdivisions were primarily driven by changes in interest rates and were not due to the credit quality of the securities. Some of these securities are guaranteed by a bond insurer, but management did not rely on the guarantee in making its investment decision. These securities will continue to be monitored as part of the Company s quarterly impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers. As a result, the Company expects to recover the entire amortized cost basis of these securities.

Cost-method investments

At September 30, 2014, cost-method investments with an aggregate cost of $1.6 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company s investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that other-than-temporary impairment charges may occur in the future.

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Other-Than-Temporarily Impaired Securities

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and has recognized the credit component of the loss in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings for credit-impaired debt securities are presented as additions in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell, or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security, the security matures or the security is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities for the respective periods are presented below.

(Dollars in thousands)	**Quarter ended September 30, 2014**	**2013**	**Nine months ended September 30, 2014**	**2013**
Balance, beginning of period Reductions:	$	$ 757	$	$ 1,257
Securities fully written down and deemed worthless				500
Balance, end of period	$	$ 757	$	$ 757

Other-Than-Temporary Impairment

The following table presents details of the other-than-temporary impairment related to securities.

(Dollars in thousands)	**Quarter ended September 30, 2014**	**2013**	**Nine months ended September 30, 2014**	**2013**
Other-than-temporary impairment charges				
Debt securities:				
Agency RMBS	$	$	$ 333	$
Total debt securities			333	
Total other-than-temporary impairment charges	$	$	$ 333	$
Other-than-temporary impairment on debt securities:				
Recorded as part of gross realized losses:				
Securities with intent to sell			333	
Total other-than-temporary impairment on debt securities	$	$	$ 333	$

Realized Gains and Losses

The following table presents the gross realized gains and losses on sales and other-than-temporary impairment charges related to securities.

(Dollars in thousands)	**Quarter ended September 30, 2014**	**2013**	**Nine months ended September 30, 2014**	**2013**

Gross realized gains	$ 429	$	$ 467	$ 685
Gross realized losses	(664)		(664)	(6)
Other-than-temporary impairment charges			(333)	
Realized (losses) gains, net	$ (235)	$	$ (530)	$ 679

NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)	September 30, 2014	December 31, 2013
Commercial and industrial	$ 52,868	$ 57,780
Construction and land development	34,189	36,479
Commercial real estate:		
Owner occupied	51,836	56,102
Other	138,241	118,818
Total commercial real estate	190,077	174,920
Residential real estate:		
Consumer mortgage	63,863	57,871
Investment property	42,692	43,835
Total residential real estate	106,555	101,706
Consumer installment	11,535	12,893
Total loans	395,224	383,778
Less: unearned income	(622)	(439)
Loans, net of unearned income	$ 394,602	$ 383,339

Loans secured by real estate were approximately 83.7% of the Company s total loan portfolio at September 30, 2014. At September 30, 2014, the Company s geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

In accordance with ASC 310, a portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. As part of the Company s quarterly assessment of the allowance, the loan portfolio is disaggregated into the following portfolio segments: commercial and industrial, construction and land development, commercial real estate, residential real estate and consumer installment. Where appropriate, the Company s loan portfolio segments are further disaggregated into classes. A class is generally determined based on the initial measurement attribute, risk characteristics of the loan, and an entity s method for monitoring and determining credit risk.

The following describe the risk characteristics relevant to each of the portfolio segments and classes.

Commercial and industrial (C&I) includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower.

Construction and land development (C&D) includes both loans and credit lines for the purpose of purchasing, carrying and developing land into commercial developments or residential subdivisions. Also included are loans and lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

Commercial real estate (CRE) includes loans disaggregated into two classes: (1) owner occupied and (2) other.

Owner occupied includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.

Other primarily includes loans to finance income-producing commercial and multi-family properties that are not owner occupied. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, warehouses and apartments leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.

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Residential real estate (RRE) includes loans disaggregated into two classes: (1) consumer mortgage and (2) investment property.

Consumer mortgage primarily includes first or second lien mortgages and home equity lines of credit to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history and property value.

Investment property primarily includes loans to finance income-producing 1-4 family residential properties. Generally the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates and property value, as well as the financial health of the borrower.

Consumer installment includes loans to individuals both secured by personal property and unsecured. Loans include personal lines of credit, automobile loans, and other retail loans. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history, and if applicable, property value.

The following is a summary of current, accruing past due and nonaccrual loans by portfolio segment and class as of September 30, 2014, and December 31, 2013.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
September 30, 2014:						
Commercial and industrial	$ 52,567	245		52,812	56	$ 52,868
Construction and land development	33,384	190		33,574	615	34,189
Commercial real estate:						
Owner occupied	51,361	203		51,564	272	51,836
Other	138,031			138,031	210	138,241
Total commercial real estate	189,392	203		189,595	482	190,077
Residential real estate:						
Consumer mortgage	63,537	12	25	63,574	289	63,863
Investment property	42,188	209	51	42,448	244	42,692
Total residential real estate	105,725	221	76	106,022	533	106,555
Consumer installment	11,472	59		11,531	4	11,535
Total	$ 392,540	918	76	393,534	1,690	$ 395,224
December 31, 2013:						
Commercial and industrial	$ 57,558	167		57,725	55	$ 57,780
Construction and land development	34,883	14		34,897	1,582	36,479
Commercial real estate:						
Owner occupied	54,214	861		55,075	1,027	56,102
Other	118,389			118,389	429	118,818
Total commercial real estate	172,603	861		173,464	1,456	174,920
Residential real estate:						
Consumer mortgage	56,191	745	69	57,005	866	57,871
Investment property	42,935	598		43,533	302	43,835
Total residential real estate	99,126	1,343	69	100,538	1,168	101,706
Consumer installment	12,789	100	4	12,893		12,893
Total	$ 376,959	2,485	73	379,517	4,261	$ 383,778

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal and independent loan review processes. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company s loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company s quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At September 30, 2014 and December 31, 2013, and for the periods then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2014 and 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Beginning with the quarter ended June 30, 2014, the Company calculated average losses for all loan segments using a rolling 20 quarter historical period in order to better capture the effects of the most

recent economic cycle on the Company s loan loss experience. Beginning with the quarter ended June 30, 2013, the Company calculated average losses for all loan segments using a rolling 8 quarter historical period (except for the commercial real estate loan segment, which used a 6 quarter historical period) and continued this methodology through March 31, 2014. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period.

If the Company continued to calculate average losses for all loan segments other than commercial real estate using a rolling 8 quarter historical period and for the commercial real estate segment using a rolling 6 quarter historical period, the Company s calculated allowance for loan loss allocation would have decreased by approximately $1.0 million at June 30, 2014. Other than the changes discussed above, the Company has not made any changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

The following table details the changes in the allowance for loan losses by portfolio segment for the respective periods.

						September 30, 2014
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Total**
Quarter ended:						
Beginning balance	$ 639	907	1,913	1,095	174	$ 4,728
Charge-offs				(287)	(39)	(326)
Recoveries	35	1		13	3	52
Net recoveries (charge-offs)	35	1		(274)	(36)	(274)
Provision for loan losses	(5)	(13)	22	262	34	300
Ending balance	$ 669	895	1,935	1,083	172	$ 4,754
Nine months ended:						
Beginning balance	$ 386	366	3,186	1,114	216	$ 5,268
Charge-offs	(46)	(236)		(358)	(83)	(723)
Recoveries	71	4	118	103	13	309
Net recoveries (charge-offs)	25	(232)	118	(255)	(70)	(414)
Provision for loan losses	258	761	(1,369)	224	26	(100)
Ending balance	$ 669	895	1,935	1,083	172	$ 4,754

						September 30, 2013
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Total**
Quarter ended:						
Beginning balance	$ 675	1,454	3,111	1,125	92	6,457
Charge-offs	(177)		(144)	(103)	(137)	$ (561)
Recoveries	23	1		21	5	$ 50
Net (charge-offs) recoveries	(154)	1	(144)	(82)	(132)	(511)
Provision for loan losses	25	(266)	137	(61)	165	$
Ending balance	$ 546	1,189	3,104	982	125	$ 5,946
Nine months ended:						
Beginning balance	$ 812	1,545	3,137	1,126	103	$ 6,723

Charge-offs		(245)	(39)	(262)	(558)	(199)	(1,303)
Recoveries		40	5	4	62	15	126
Net charge-offs		(205)	(34)	(258)	(496)	(184)	(1,177)
Provision for loan losses		(61)	(322)	225	352	206	400
Ending balance	$	546	1,189	3,104	982	125	$ 5,946

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The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of September 30, 2014 and 2013.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
(In thousands)	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
September 30, 2014:						
Commercial and industrial	$ 669	52,785		83	669	52,868
Construction and land development	895	33,574		615	895	34,189
Commercial real estate	1,733	188,150	202	1,927	1,935	190,077
Residential real estate	1,083	105,672		883	1,083	106,555
Consumer installment	172	11,535			172	11,535
Total	$ 4,552	391,716	202	3,508	4,754	395,224
September 30, 2013:						
Commercial and industrial	$ 546	58,630		136	546	58,766
Construction and land development	1,090	35,469	99	1,593	1,189	37,062
Commercial real estate	2,919	167,564	185	2,956	3,104	170,520
Residential real estate	982	101,576		989	982	102,565
Consumer installment	125	12,170			125	12,170
Total	$ 5,662	375,409	284	5,674	5,946	381,083

(1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans.
(2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

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Credit Quality Indicators

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for qualitative and environmental factors and are defined as follows:

Pass loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.

Special Mention loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company s position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.

Substandard Accruing loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected

Nonaccrual includes loans where management has determined that full payment of principal and interest is not expected.

(In thousands)		Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
September 30, 2014:						
Commercial and industrial	$	48,075	4,308	429	56	$ 52,868
Construction and land development		32,524	483	567	615	34,189
Commercial real estate:						
Owner occupied		50,185	1,149	230	272	51,836
Other		137,285	89	657	210	138,241
Total commercial real estate		187,470	1,238	887	482	190,077
Residential real estate:						
Consumer mortgage		55,804	3,085	4,685	289	63,863
Investment property		40,359	876	1,213	244	42,692
Total residential real estate		96,163	3,961	5,898	533	106,555
Consumer installment		11,398	17	116	4	11,535
Total	$	375,630	10,007	7,897	1,690	$ 395,224
December 31, 2013:						
Commercial and industrial	$	53,060	4,183	482	55	$ 57,780
Construction and land development		33,616	180	1,101	1,582	36,479
Commercial real estate:						
Owner occupied		53,430	770	875	1,027	56,102
Other		117,490	91	808	429	118,818
Total commercial real estate		170,920	861	1,683	1,456	174,920
Residential real estate:						
Consumer mortgage		50,392	1,137	5,476	866	57,871
Investment property		40,517	1,310	1,706	302	43,835
Total residential real estate		90,909	2,447	7,182	1,168	101,706
Consumer installment		12,713	34	146		12,893
Total	$	361,218	7,705	10,594	4,261	$ 383,778

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Impaired loans

The following tables present details related to the Company s impaired loans. Loans which have been fully charged-off do not appear in the following table. The related allowance generally represents the following components which correspond to impaired loans:

Individually evaluated impaired loans equal to or greater than $500,000 secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate loans).

Individually evaluated impaired loans equal to or greater than $250,000 not secured by real estate (nonaccrual commercial and industrial and consumer installment loans).

The following tables set forth certain information regarding the Company s impaired loans that were individually evaluated for impairment at September 30, 2014 and December 31, 2013.

	September 30, 2014					
(In thousands)		Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)		Related allowance
With no allowance recorded:						
Commercial and industrial	$	83		83		
Construction and land development		2,829	(2,214)	615		
Commercial real estate:						
Owner occupied		336	(64)	272		
Other		300	(91)	209		
Total commercial real estate		636	(155)	481		
Residential real estate:						
Consumer mortgages		939	(216)	723		
Investment property		204	(44)	160		
Total residential real estate		1,143	(260)	883		
Total	$	4,691	(2,629)	2,062	$	
With allowance recorded:						
Commercial real estate:						
Owner occupied		854		854		110
Other		592		592		92
Total commercial real estate		1,446		1,446		202
Total	$	1,446		1,446	$	202
Total impaired loans	$	6,137	(2,629)	3,508	$	202

(1) Unpaid principal balance represents the contractual obligation due from the customer.

(2)

Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance subsequent to the loans being placed on nonaccrual status.

(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

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(In thousands)		December 31, 2013 Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)		Related allowance
With no allowance recorded:						
Commercial and industrial	$	124		124		
Construction and land development		2,879	(1,682)	1,197		
Commercial real estate:						
Owner occupied		1,217	(190)	1,027		
Other		518	(89)	429		
Total commercial real estate		1,735	(279)	1,456		
Residential real estate:						
Consumer mortgages		952	(198)	754		
Investment property		207	(35)	172		
Total residential real estate		1,159	(233)	926		
Total	$	5,897	(2,194)	3,703		
With allowance recorded:						
Construction and land development		452	(67)	385		88
Commercial real estate:						
Owner occupied		875		875		110
Other		602		602		62
Total commercial real estate		1,477		1,477		172
Total	$	1,929	(67)	1,862	$	260
Total impaired loans	**$**	7,826	(2,261)	5,565	$	260

(1) Unpaid principal balance represents the contractual obligation due from the customer.
(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance subsequent to the loans being placed on nonaccrual status.
(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class during the respective periods.

(In thousands)		Quarter ended September 30, 2014 Average recorded investment	Total interest income recognized	Nine months ended September 30, 2014 Average recorded investment	Total interest income recognized
Impaired loans:					
Commercial and industrial	$	88	2	105	6
Construction and land development		730		1,159	
Commercial real estate:					
Owner occupied		1,129	9	1,367	31
Other		801	4	935	20

Total commercial real estate		1,930	13	2,302	51
Residential real estate:					
Consumer mortgages		716	5	752	5
Investment property		162		166	
Total residential real estate		878	5	918	5
Total	$	3,626	20	4,484	62

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(In thousands)		Quarter ended September 30, 2013 Average recorded investment	Total interest income recognized	Nine months ended September 30, 2013 Average recorded investment	Total interest income recognized
Impaired loans:					
Commercial and industrial	$	139	2	152	7
Construction and land development		1,596		1,608	
Commercial real estate:					
Owner occupied		1,927	13	1,993	42
Other		832	4	1,581	4
Total commercial real estate		2,759	17	3,574	46
Residential real estate:					
Consumer mortgages		776		801	
Investment property		231		323	
Total residential real estate		1,007		1,124	
Total	$	5,501	19	6,458	53

Troubled Debt Restructurings

Impaired loans also include troubled debt restructurings (TDRs). In the normal course of business, management may grant concessions to borrowers that are experiencing financial difficulty. A concession may include, but is not limited to, delays in required payments of principal and interest for a specified period, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect all amounts due, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. In making the determination of whether a loan modification is a TDR, the Company considers the individual facts and circumstances surrounding each modification. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructure.

Similar to other impaired loans, TDRs are measured for impairment based on the present value of expected payments using the loan s original effective interest rate as the discount rate, or the fair value of the collateral, less selling costs if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, impairment is recognized by establishing a valuation allowance as part of the allowance for loan losses or a charge-off to the allowance for loan losses. In periods subsequent to the modification, all TDRs are individually evaluated for possible impairment.

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The following is a summary of accruing and nonaccrual TDRs, which are included in impaired loan totals, and the related allowance for loan losses, by portfolio segment and class as of September 30, 2014, and December 31, 2013.

	TDRs			
(In thousands)	**Accruing**	**Nonaccrual**	**Total**	**Related Allowance**
September 30, 2014				
Commercial and industrial	$ 83		83	$
Construction and land development		615	615	
Commercial real estate:				
Owner occupied	854	272	1,126	110
Other	592	209	801	92
Total commercial real estate	1,446	481	1,927	202
Residential real estate:				
Consumer mortgages	723		723	
Investment property		160	160	
Total residential real estate	723	160	883	
Total	$ 2,252	1,256	3,508	$ 202
December 31, 2013				
Commercial and industrial	$ 124		124	$
Construction and land development		1,582	1,582	88
Commercial real estate:				
Owner occupied	875	285	1,160	110
Other	602	429	1,031	62
Total commercial real estate	1,477	714	2,191	172
Residential real estate:				
Consumer mortgages		754	754	
Investment property		172	172	
Total residential real estate		926	926	
Total	$ 1,601	3,222	4,823	$ 260

At September 30, 2014, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

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The following table summarizes loans modified in a TDR during the respective periods both before and after their modification.

(Dollars in thousands)	Quarter ended September 30, Number of contracts		Pre-modification outstanding recorded investment	Post - modification outstanding recorded investment	Nine months ended September 30, Number of contracts		Pre-modification outstanding recorded investment	Post - modification outstanding recorded investment
2014:								
Commercial real estate:								
Other	1	$	590	592	1	$	590	592
Total commercial real estate	1		590	592	1		590	592
Residential real estate:								
Consumer mortgages	1		712	712	1		712	712
Total residential real estate	1		712	712	1		712	712
Total	2	$	1,302	1,304	2	$	1,302	1,304
2013:								
Commercial real estate:								
Owner occupied	1	$	882	882	1	$	882	882
Other	1		606	610	2		1,037	1,041
Total commercial real estate	2		1,488	1,492	3		1,919	1,923
Residential real estate:								
Consumer mortgages	1		678	674	2		808	804
Total residential real estate	1		678	674	2		808	804
Total	3	$	2,166	2,166	5	$	2,727	2,727

The majority of the loans modified in a TDR during the quarter and nine months ended September 30, 2014 and 2013, respectively, included permitting delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was considered to be less than a market rate.

The following table summarizes the recorded investment in loans modified in a TDR within the previous 12 months for which there was a payment default (defined as 90 days or more past due) during the respective periods.

(Dollars in thousands)	Quarter ended September 30, Number of Contracts		Recorded investment[(1)]	Nine months Ended September 30, Number of Contracts		Recorded investment[(1)]
2014:						
Commerical real estate:						
Owner occupied	1	$	272	1	$	272
Total commercial real estate	1		272	1		272

Total	1	$	272	1	$	272
2013:						
Construction and land development		$		1	$	1,197
Commerical real estate:						
Other	1		426	1		426
Total commercial real estate	1		426	1		426
Total	1	$	426	2	$	1,623

(1) Amount as of applicable month end during the respective period for which there was a payment default.

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NOTE 6: MORTGAGE SERVICING RIGHTS, NET

Mortgage servicing rights (MSRs) are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are sold. An estimate of the fair value of the Company s MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income.

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. MSRs are included in other assets on the accompanying consolidated balance sheets.

The Company evaluates MSRs for impairment on a quarterly basis. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance is established. The valuation allowance is adjusted as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

The following table details the changes in amortized MSRs and the related valuation allowance for the respective periods.

	Quarter ended September 30,		Nine months ended September 30,	
(Dollars in thousands)	**2014**	**2013**	**2014**	**2013**
MSRs, net:				
Beginning balance	$ 2,346	$ 1,979	$ 2,350	$ 1,526
Additions, net	168	215	371	693
Amortization expense	(89)	(78)	(253)	(304)
Decrease (increase) in valuation allowance	12	172	(31)	373
Ending balance	$ 2,437	$ 2,288	$ 2,437	$ 2,288
Valuation allowance included in MSRs, net:				
Beginning of period	$ 43	$ 185	$	$ 386
End of period	31	13	31	13
Fair value of amortized MSRs:				
Beginning of period	$ 3,228	$ 2,453	$ 3,452	$ 1,526
End of period	3,314	3,167	3,314	3,167

NOTE 7: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities on the accompanying Consolidated Balance Sheets. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings within other noninterest income on the accompanying consolidated statements of earnings. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these swaps, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At September 30, 2014 and December 31, 2013, the Company had no derivative contracts to assist in managing its own interest rate sensitivity.

Interest rate swap agreements involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument is negative, the Company owes the customer or counterparty and therefore, has no credit risk.

A summary of the Company s interest rate swap agreements at September 30, 2014 and December 31, 2013 is presented below.

(Dollars in thousands)		Notional	Other Assets Estimated Fair Value	Other Liabilities Estimated Fair Value
September 30, 2014:				
Pay fixed / receive variable	$	4,754		669
Pay variable / receive fixed		4,754	669	
Total interest rate swap agreements	$	9,508	669	669
December 31, 2013:				
Pay fixed / receive variable	$	5,017		844
Pay variable / receive fixed		5,017	844	
Total interest rate swap agreements	$	10,034	844	844

NOTE 8: FAIR VALUE

Fair Value Hierarchy

Fair value is defined by ASC 820, *Fair Value Measurements and Disclosures*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for an asset or liability at the measurement date. GAAP establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs to the valuation methodology are unobservable and reflect the Company s own assumptions about the inputs market participants would use in pricing the asset or liability.

Level changes in fair value measurements

Transfers between levels of the fair value hierarchy are generally recognized at the end of the reporting period. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company s financial assets and liabilities generally is such that transfers in and out of any level are expected to be infrequent. For the nine months ended September 30, 2014, there were no transfers between levels and no changes in valuation techniques for the Company s financial assets and liabilities.

Assets and liabilities measured at fair value on a recurring basis

Securities available-for-sale

Fair values of securities available for sale were primarily measured using Level 2 inputs. For these securities, the Company obtains pricing from third party pricing services. These third party pricing services consider observable data that may include broker/dealer quotes, market spreads, cash flows, market consensus prepayment speeds, benchmark yields, reported trades for similar securities, market consensus prepayment speeds, credit information and the securities terms and conditions. On a quarterly basis, management reviews the pricing received from the third party pricing services for reasonableness given current market conditions. As part of its review, management may obtain non-binding third party broker quotes to validate the fair value measurements. In addition, management will periodically submit pricing provided by the third party pricing services to another independent valuation firm on a sample basis. This independent valuation firm will compare the price provided by the third party pricing service with its own price and will review the significant assumptions and valuation methodologies used with management.

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Interest rate swap agreements

The carrying amount of interest rate swap agreements was included in other assets and accrued expenses and other liabilities on the accompanying consolidated balance sheets. The fair value measurements for our interest rate swap agreements were based on information obtained from a third party bank. This information is periodically tested by the Company and validated against other third party valuations. If needed, other third party market participants may be utilized to corroborate the fair value measurements for our interest rate swap agreements. The Company classified these derivative assets and liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013, respectively, by caption, on the accompanying consolidated balance sheets by ASC 820 valuation hierarchy (as described above).

(Dollars in thousands)	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
September 30, 2014:				
Securities available-for-sale:				
Agency obligations	$ 59,503		59,503	
Agency RMBS	139,184		139,184	
State and political subdivisions	66,140		66,140	
Total securities available-for-sale	264,827		264,827	
Other assets [(1)]	&			