

UNITY BANCORP INC /NJ/
Form 10-Q
November 08, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from ____ to ____.

Commission File Number 1-12431

Unity Bancorp, Inc.

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(Exact name of registrant as specified in its charter)

New Jersey 22-3282551
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

64 Old Highway 22, Clinton, NJ 08809
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (908) 730-7630

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, as amended, during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act):

Large accelerated filer Accelerated filer Nonaccelerated filer Smaller reporting company

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

Yes No

The number of shares outstanding of each of the registrant's classes of common equity stock, as of November 1, 2013
common stock, no par value: 7,548,126 shares outstanding

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PART I CONSOLIDATED FINANCIAL INFORMATION

ITEM 1 Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

(In thousands)	September 30, 2013	December 31, 2012
ASSETS		
Cash and due from banks	\$ 27,602	\$ 23,705
Federal funds sold and interest-bearing deposits	47,124	70,487
Cash and cash equivalents	74,726	94,192
Securities:		
Securities available for sale	80,926	89,538
Securities held to maturity (fair value of \$25,261 and \$22,741, respectively)	25,980	21,515
Total securities	106,906	111,053
Loans:		
SBA loans held for sale	5,893	6,937
SBA loans held to maturity	50,445	58,593
SBA 504 loans	37,041	41,438
Commercial loans	348,625	301,564
Residential mortgage loans	173,129	132,094
Consumer loans	45,484	46,410
Total loans	660,617	587,036
Allowance for loan losses	(13,550)	(14,758)
Net loans	647,067	572,278
Premises and equipment, net	15,671	12,062
Bank owned life insurance ("BOLI")	12,648	9,402
Deferred tax assets	6,880	5,954
Federal Home Loan Bank stock	3,952	3,989
Accrued interest receivable	3,131	3,298
Other real estate owned ("OREO")	1,249	1,826
Prepaid FDIC insurance	-	1,929
Goodwill and other intangibles	1,516	1,516
Other assets	2,355	2,231
Total assets	\$ 876,101	\$ 819,730
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Noninterest-bearing demand deposits	\$ 163,617	\$ 114,424

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Interest-bearing demand deposits	119,579	114,838
Savings deposits	280,892	294,533
Time deposits, under \$100,000	95,990	76,994
Time deposits, \$100,000 and over	67,034	47,971
Total deposits	727,112	648,760
Borrowed funds	75,000	75,000
Subordinated debentures	15,465	15,465
Accrued interest payable	430	434
Accrued expenses and other liabilities	2,155	2,561
Total liabilities	820,162	742,220
Commitments and contingencies	-	-
Shareholders' equity:		
Cumulative perpetual preferred stock	-	20,115
Common stock	51,944	54,274
Retained earnings	4,408	1,788
Accumulated other comprehensive income (loss)	(413)	1,333
Total shareholders' equity	55,939	77,510
Total liabilities and shareholders' equity	\$ 876,101	\$ 819,730
Preferred shares	-	21
Issued and outstanding common shares	7,546	7,534

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.

Consolidated Statements of Income

(Unaudited)

(In thousands, except per share amounts)	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	\$ 9	\$ 13	\$ 31	\$ 56
Federal Home Loan Bank stock	40	50	118	144
Securities:				
Taxable	591	694	1,858	2,177
Tax-exempt	109	108	354	371
Total securities	700	802	2,212	2,548
Loans:				
SBA loans	586	881	2,141	2,652
SBA 504 loans	411	647	1,503	2,098
Commercial loans	4,387	4,313	12,638	12,707
Residential mortgage loans	1,861	1,631	5,060	4,869
Consumer loans	480	534	1,485	1,624
Total loans	7,725	8,006	22,827	23,950
Total interest income	8,474	8,871	25,188	26,698
INTEREST EXPENSE				
Interest-bearing demand deposits	90	108	281	368
Savings deposits	183	293	524	933
Time deposits	510	619	1,593	2,222
Borrowed funds and subordinated debentures	820	824	2,428	2,486
Total interest expense	1,603	1,844	4,826	6,009
Net interest income	6,871	7,027	20,362	20,689
Provision for loan losses	600	1,000	1,550	3,200
Net interest income after provision for loan losses	6,271	6,027	18,812	17,489
NONINTEREST INCOME				
Branch fee income	398	383	1,093	1,131
Service and loan fee income	351	366	975	954
Gain on sale of SBA loans held for sale, net	280	46	607	427
Gain on sale of mortgage loans, net	314	662	1,339	1,526
BOLI income	100	74	246	220
Net security gains	34	7	367	514
Other income	173	236	505	558
Total noninterest income	1,650	1,774	5,132	5,330
NONINTEREST EXPENSE				
Compensation and benefits	2,984	3,191	9,325	9,505
Occupancy	598	690	1,918	2,038
Processing and communications	598	544	1,720	1,631
Furniture and equipment	374	368	1,110	1,085

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Professional services	210	196	634	598
Loan collection costs	188	182	594	453
OREO expenses	174	36	364	398
Deposit insurance	165	162	493	502
Advertising	218	181	519	630
Other expenses	426	449	1,457	1,319
Total noninterest expense	5,935	5,999	18,134	18,159
Income before provision for income taxes	1,986	1,802	5,810	4,660
Provision for income taxes	684	606	1,962	1,583
Net income	1,302	1,196	3,848	3,077
Preferred stock dividends and discount accretion	119	397	988	1,195
Income available to common shareholders	\$ 1,183	\$ 799	\$ 2,860	\$ 1,882
Net income per common share - Basic	\$ 0.16	\$ 0.11	\$ 0.38	\$ 0.25
Net income per common share - Diluted	\$ 0.15	\$ 0.10	\$ 0.36	\$ 0.24
Weighted average common shares outstanding - Basic	7,545	7,473	7,542	7,465
Weighted average common shares outstanding - Diluted	7,822	7,782	7,867	7,786

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

(In thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Net income	\$ 1,302	\$ 1,196	\$ 3,848	\$ 3,077
Other comprehensive income (loss), net of tax:				
Unrealized holding gains (losses) on securities arising during period	(618)	286	(1,502)	431
Less: Reclassification adjustment for gains on securities included in net income	22	-	244	337
Total other comprehensive income (loss)	(640)	286	(1,746)	94
Total comprehensive income	\$ 662	\$ 1,482	\$ 2,102	\$ 3,171

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.

Consolidated Statements of Changes in Shareholders' Equity

For the nine months ended September 30, 2013 and 2012

(Unaudited)

(In thousands)	Preferred stock	Common stock		Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
		Shares	Amount			
Balance, December 31, 2012	\$ 20,115	7,534	\$ 54,274	\$ 1,788	\$ 1,333	\$ 77,510
Net income				3,848		3,848
Other comprehensive loss, net of tax					(1,746)	(1,746)
Redemption of perpetual preferred stock from U.S. Treasury	(20,649)					(20,649)
Repurchase of warrants from U.S. Treasury			(2,617)	(90)		(2,707)
Accretion of discount on preferred stock	534			(534)		-
Dividends on common stock (\$0.01 per share)			33	(150)		(117)
Dividends on preferred stock (5% annually)				(454)		(454)
Common stock issued and related tax effects (1)		12	254			254
Balance, September 30, 2013	\$ -	7,546	\$ 51,944	\$ 4,408	\$ (413)	\$ 55,939

(In thousands)	Preferred stock	Common stock		Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
		Shares	Amount	(deficit)		
Balance, December 31, 2011	\$ 19,545	7,459	\$ 53,746	\$ (854)	\$ 1,121	\$ 73,558
Net income				3,077		3,077
Other comprehensive income, net of tax					94	94
Accretion of discount on preferred stock	423			(423)		-
Dividends on preferred stock (5% annually)				(772)		(772)
Common stock issued and related tax effects (1)		44	430			430
Balance, September 30, 2012	\$ 19,968	7,503	\$ 54,176	\$ 1,028	\$ 1,215	\$ 76,387

(1) Includes the issuance of common stock under employee benefit plans, which includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

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Unity Bancorp, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	For the nine months ended September 30,	
	2013	2012
OPERATING ACTIVITIES:		
Net income	\$ 3,848	\$ 3,077
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,550	3,200
Net amortization of purchase premiums and discounts on securities	550	638
Depreciation and amortization	961	999
Deferred income tax expense	225	594
Net security gains	(367)	(514)
Stock compensation expense	250	234
Loss on sale of OREO	61	77
Valuation writedowns on OREO	170	30
Gain on sale of mortgage loans held for sale, net	(1,339)	(1,526)
Gain on sale of SBA loans held for sale, net	(607)	(427)
Origination of mortgage loans held for sale	(62,589)	(71,568)
Origination of SBA loans held for sale	(5,323)	(4,700)
Proceeds from sale of mortgage loans held for sale, net	63,928	73,094
Proceeds from sale of SBA loans held for sale, net	6,940	5,087
Loss on sale or disposal of premises and equipment	5	23
Net change in other assets and liabilities	1,451	1,398
Net cash provided by operating activities	9,714	9,716
INVESTING ACTIVITIES		

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Purchases of securities held to maturity	(8,578)	(624)
Purchases of securities available for sale	(25,863)	(32,802)
Purchases of Federal Home Loan Bank stock, at cost	(3,224)	-
Maturities and principal payments on securities held to maturity	3,983	3,706
Maturities and principal payments on securities available for sale	19,370	24,172
Proceeds from sales of securities available for sale	12,155	6,638
Proceeds from redemption of Federal Home Loan Bank stock	3,261	99
Proceeds from sale of OREO	1,146	3,525
Net increase in loans	(78,238)	(11,499)
Purchase of BOLI	(3,000)	-
Proceeds from sale or disposal of premises and equipment	1	12
Purchases of premises and equipment	(4,487)	(1,493)
Net cash used in investing activities	(83,474)	(8,266)
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	78,352	(10,844)
Redemption of perpetual preferred stock from U.S. Treasury	(20,649)	-
Repurchase of warrant from U.S. Treasury	(2,707)	-
Proceeds from exercise of stock options	-	157
Dividends on preferred stock	(585)	(774)
Dividends on common stock	(117)	-
Net cash provided by (used in) financing activities	54,294	(11,461)
Decrease in cash and cash equivalents	(19,466)	(10,011)
Cash and cash equivalents, beginning of period	94,192	82,574
Cash and cash equivalents, end of period	\$ 74,726	\$ 72,563
SUPPLEMENTAL DISCLOSURES		

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Cash:

Interest paid	\$	4,830	\$	6,068
Income taxes paid		2,047		939
Noncash investing activities:				
Transfer of SBA loans held for sale to held to maturity		34		-
Transfer of loans to OREO		800		2,772

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements

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Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

September 30, 2013

NOTE 1. Significant Accounting Policies

The accompanying Consolidated Financial Statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and other real estate owned ("OREO") properties. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation, with no impact on current earnings or shareholders' equity. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting periods. Actual results could differ from those estimates. Amounts requiring the use of significant estimates include the allowance for loan losses, valuation of deferred tax and servicing assets, the carrying value of loans held for sale and other real estate owned, the valuation of securities and the determination of other-than-temporary impairment for securities and fair value disclosures. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the Consolidated Financial Statements included in this Quarterly Report on Form 10-Q were available to be issued.

The interim unaudited Consolidated Financial Statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC") and consist of normal recurring adjustments necessary for the fair presentation of interim results. The results of operations for the nine months ended September 30, 2013 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by U.S. generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Stock Transactions

Stock Option Plans

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. Transactions under the Company's stock option plans for the nine months ended September 30, 2013 are summarized in the following table:

	Shares	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value
Outstanding at December 31, 2012	516,332	\$ 7.06	5.4	\$ 327,725
Options granted	25,000	6.02		
Options exercised	(11,667)	6.62		
Options forfeited	(8,333)	6.56		
Options expired	(2,617)	8.86		
Outstanding at September 30, 2013	518,715	\$ 7.02	4.8	\$ 669,827
Exercisable at September 30, 2013	422,217	\$ 7.19	4.0	\$ 554,078

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of September 30, 2013, 1,720,529 shares have been reserved for issuance upon the exercise of options 518,715 option grants are outstanding, and 1,102,073 option grants have been exercised, forfeited or expired, leaving 99,741 shares available for grant.

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The fair values of the options granted during the three and nine months ended September 30, 2013 and 2012 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Number of options granted	-	-	25,000	2,500
Weighted average exercise price	\$ -	\$ -	\$ 6.02	\$ 5.95
Weighted average fair value of options	\$ -	\$ -	\$ 2.91	\$ 2.79
Expected life in years (1)	-	-	5.11	4.72
Expected volatility (2)	- %	- %	52.81 %	56.33 %
Risk-free interest rate (3)	- %	- %	0.77 %	0.72 %
Dividend yield (4)	- %	- %	- %	- %

- (1) The expected life of the options was estimated based on historical employee behavior and represents the period of time that options granted are expected to be outstanding.
- (2) The expected volatility of the Company's stock price was based on the historical volatility over the period commensurate with the expected life of the options.
- (3) The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the date of grant.
- (4) The expected dividend yield is the projected annual yield based on the grant date stock price.

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options. The following table presents information about options exercised during the three and nine months ended September 30, 2013 and 2012:

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Number of options exercised	11,667	107,367	11,667	111,208
Total intrinsic value of options exercised	\$ 15,367	\$ 109,896	\$ 15,367	\$ 115,951
Cash received from options exercised	-	139,943	-	156,988
Tax deduction realized from options exercised	-	40,401	-	40,913

The following table summarizes information about stock options outstanding and exercisable at September 30, 2013:

Range of exercise prices	Options outstanding		Options exercisable		
	Options outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
\$ 0.00 - 4.00	119,750	5.6	\$ 3.87	119,750	\$ 3.87
4.01 - 8.00	236,675	6.9	6.45	140,177	6.59
8.01 - 12.00	117,639	0.5	9.23	117,639	9.23
12.01 - 16.00	44,651	3.3	12.62	44,651	12.62
Total	518,715	4.8	\$ 7.02	422,217	\$ 7.19

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period).

Compensation expense related to stock options and the related income tax benefit for the three and nine months ended September 30, 2013 and 2012 are detailed in the following table:

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Compensation expense	\$ 30,431	\$ 38,167	\$ 105,076	\$ 113,631
Income tax benefit	12,154	11,935	41,967	40,333

As of September 30, 2013, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately \$182 thousand. That cost is expected to be recognized over a weighted average period of 1.7 years.

Restricted Stock Awards

Restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time. The following table summarizes nonvested restricted stock activity for the nine months ended September 30, 2013:

	Shares	Average grant date fair value
Nonvested restricted stock at December 31, 2012	90,975	\$ 6.10
Granted	14,000	6.02
Vested	(9,275)	5.97
Forfeited	(6,650)	6.16
Nonvested restricted stock at September 30, 2013	89,050	\$ 6.10

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into salary expense on a straight line basis over the vesting period. As of September 30, 2013, 471,551 shares of restricted stock were reserved for issuance, of which 261,313 shares are available for grant.

Restricted stock awards granted during the three and nine months ended September 30, 2013 and 2012 were as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Number of shares granted	-	-	14,000	1,000
Average grant date fair value	\$ -	\$ -	\$ 6.02	\$ 5.95

Compensation expense related to restricted stock for the three and nine months ended September 30, 2013 and 2012 is detailed in the following table:

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Compensation expense	\$ 50,628	\$ 39,301	\$ 145,014	\$ 120,413

As of September 30, 2013, there was approximately \$414 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 2.6 years.

Perpetual Preferred Stock

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008 ("EESA"), which provided the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to the U.S. markets. One of the programs resulting from the EESA was the Treasury's Capital Purchase Program ("CPP") which provided direct equity investment of perpetual preferred stock by the U.S. Treasury in qualified financial institutions. The Company received an investment in perpetual preferred stock of \$20.6 million on December 5, 2008.

On May 9, 2013, the Company announced that it received approval of its application from the U.S. Department of Treasury to redeem half of the 20,649 shares of preferred stock issued in connection with the Company's participation in the Treasury's CPP. On May 15, 2013, the Company paid \$10.3 million to the Treasury to repurchase 10,324 shares of the preferred stock, including accrued and unpaid dividends for the shares. On July 1, 2013, the Company announced that it received approval to redeem the remaining 10,325 shares of preferred stock. On July 3, 2013, the Company paid \$10.4 million to the Treasury to repurchase the remaining shares of the preferred stock, including accrued and unpaid dividends for the shares. On August 28, 2013, the Company completed the \$2.7 million repurchase of the warrant to purchase 764,788 shares of the Company's common stock issued to the U.S. Department of the Treasury as part of the Company's participation in the Treasury's CPP.

Other-Than-Temporary Impairment

The Company has a process in place to identify debt securities that could potentially incur credit impairment that is other-than-temporary. This process involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. This evaluation considers relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other-than-temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below

cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) for fixed maturity securities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and for equity securities, our ability and intent to hold the security for a forecasted period of time that allows for the recovery in value.

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Management assesses its intent to sell or whether it is more likely than not that it will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired with no intent to sell and no requirement to sell prior to recovery of its amortized cost basis, the amount of the impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income. For debt securities where management has the intent to sell, the amount of the impairment is reflected in earnings as realized losses.

The present value of expected future cash flows is determined using the best estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds and structural support, including subordination and guarantees. The corporate bond cash flow estimates are derived from scenario-based outcomes of expected corporate restructurings or the disposition of assets using bond specific facts and circumstances including timing, security interests and loss severity.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Loans

Loans Held for Sale

Loans held for sale represent the guaranteed portion of SBA loans and are reflected at the lower of aggregate cost or market value. The Company originates loans to customers under an SBA program that historically has provided for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. The net amount of loan origination fees on loans sold is included in the carrying value and in the gain or loss on the sale. When sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income. All criteria for sale accounting must be met in order for the loan sales to occur; see details under the "Transfers of Financial Assets" heading above.

Servicing assets represent the estimated fair value of retained servicing rights, net of servicing costs, at the time loans are sold. Servicing assets are amortized in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on stratifying the underlying financial assets by date of origination and term. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment, if temporary, would be reported as a valuation allowance.

Serviced loans sold to others are not included in the accompanying Consolidated Balance Sheets. Income and fees collected for loan servicing are credited to noninterest income when earned, net of amortization on the related servicing assets.

Loans Held to Maturity

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and deferred loan origination fees and costs. In accordance with the level yield method, loan origination fees, net of direct loan origination costs, are deferred and recognized over the estimated life of the related loans as an adjustment to the loan yield. Interest is credited to operations primarily based upon the principal balance outstanding.

Loans are reported as past due when either interest or principal is unpaid in the following circumstances: fixed payment loans when the borrower is in arrears for two or more monthly payments; open end credit for two or more billing cycles; and single payment notes if interest or principal remains unpaid for 30 days or more.

Nonperforming loans consist of loans that are not accruing interest as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt (nonaccrual loans). When a loan is classified as nonaccrual, interest accruals are discontinued and all past due interest previously recognized as income is reversed and charged against current period earnings. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans may be returned to an accrual status when the ability to collect is reasonably assured and when the loan is brought current as to principal and interest.

Loans are charged off when collection is sufficiently questionable and when the Company can no longer justify maintaining the loan as an asset on the balance sheet. Loans qualify for charge-off when, after thorough analysis, all possible sources of repayment are insufficient. These include: 1) potential future cash flows, 2) value of collateral, and/or 3) strength of co-makers and guarantors. All unsecured loans are charged off upon the establishment of the loan's nonaccrual status. Additionally, all loans classified as a loss or that portion of the loan classified as a loss is charged off. All loan charge-offs are approved by the Board of Directors.

Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the paragraphs above.

The Company evaluates its loans for impairment. A loan is considered 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. The Company has defined impaired loans to be all TDRs and nonperforming loans. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for all other loans. Impairment of a loan is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or as a practical expedient, based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral-dependent. If the value of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge to the provision for loan losses.

For additional information on loans, see Note 8 to the Consolidated Financial Statements and the section titled "Loan Portfolio" under Item 2. Management's Discussion and Analysis.

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

The allowance for loan losses is maintained at a level management considers adequate to provide for probable loan losses as of the balance sheet date. The allowance is increased by provisions charged to expense and is reduced by net charge-offs.

The level of the allowance is based on management's evaluation of probable losses in the loan portfolio, after consideration of prevailing economic conditions in the Company's market area, the volume and composition of the loan portfolio, and historical loan loss experience. The allowance for loan losses consists of specific reserves for individually impaired credits and TDRs, reserves for nonimpaired loans based on historical loss factors and reserves based on general economic factors and other qualitative risk factors such as changes in delinquency trends, industry concentrations or local/national economic trends. This risk assessment process is performed at least quarterly, and, as adjustments become necessary, they are realized in the periods in which they become known.

Although management attempts to maintain the allowance at a level deemed adequate to provide for probable losses, future additions to the allowance may be necessary based upon certain factors including changes in market conditions and underlying collateral values. In addition, various regulatory agencies periodically review the adequacy of the Company's allowance for loan losses. These agencies may require the Company to make additional provisions based on their judgments about information available to them at the time of their examination.

The Company maintains an allowance for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the allowance are made through other expenses and applied to the allowance which is maintained in other liabilities.

For additional information on the allowance for loan losses and unfunded loan commitments, see Note 9 to the Consolidated Financial Statements and the sections titled "Asset Quality" and "Allowance for Loan Losses and Reserve for Unfunded Loan Commitments" under Item 2. Management's Discussion and Analysis.

Income Taxes

The Company accounts for income taxes according to the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that ultimately would be sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. The evaluation of a tax position taken is considered by itself and not offset or aggregated with other positions. Tax positions that meet the more likely than not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits would be recognized in income tax expense on the income statement.

NOTE 2. Litigation

The Company may, in the ordinary course of business, become a party to litigation involving collection matters, contract claims and other legal proceedings relating to the conduct of its business. In the best judgment of management, based upon consultation with counsel, the consolidated financial position and results of operations of the Company will not be affected materially by the final outcome of any pending legal proceedings or other contingent liabilities and commitments.

NOTE 3. Net Income per Share

Basic net income per common share is calculated as net income available to common shareholders divided by the weighted average common shares outstanding during the reporting period. Net income available to common shareholders is calculated as net income less accrued dividends and discount accretion related to preferred stock.

Diluted net income per common share is computed similarly to that of basic net income per common share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options and warrants, were issued during the reporting period utilizing the Treasury stock method.

The following is a reconciliation of the calculation of basic and diluted income per share.

(In thousands, except per share amounts)	For the three months ended		For the nine months ended	
	September 30, 2013	2012	September 30, 2013	2012
Net income	\$ 1,302	\$ 1,196	\$ 3,848	\$ 3,077
Less: Preferred stock dividends and discount accretion	119	397	988	1,195
Income available to common shareholders	\$ 1,183	\$ 799	\$ 2,860	\$ 1,882
Weighted average common shares outstanding - Basic	7,545	7,473	7,542	7,465
Plus: Potential dilutive common stock equivalents	277	309	325	321
Weighted average common shares outstanding - Diluted	7,822	7,782	7,867	7,786
Net income per common share - Basic	\$ 0.16	\$ 0.11	\$ 0.38	\$ 0.25
Net income per common share - Diluted	0.15	0.10	0.36	0.24
Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive	282	499	383	505

The "potential dilutive common stock equivalents" shown in the table above includes the impact of 764,778 common stock warrants issued to the U.S. Department of Treasury under the Capital Purchase Program in December 2008,

utilizing the Treasury stock method. These warrants were repurchased on August 28, 2013 for a price of \$2.7 million utilizing the Treasury Stock Method for the period outstanding.

NOTE 4. Income Taxes

The Company follows FASB ASC Topic 740, "Income Taxes," which prescribes a threshold for the financial statement recognition of income taxes and provides criteria for the measurement of tax positions taken or expected to be taken in a tax return. ASC 740 also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of income taxes.

For the quarter ended September 30, 2013, the Company reported income tax expense of \$684 thousand for an effective tax rate of 34.4 percent, compared to an income tax expense of \$606 thousand and effective tax rate of 33.6 percent for the prior year's quarter. For the nine months ended September 30, 2013, the Company reported income tax expense of \$2.0 million for an effective tax rate of 33.8 percent, compared to an income tax expense of \$1.6 million and effective tax rate of 34.0 percent for the nine months ended September 30, 2012.

The Company did not recognize or accrue any interest or penalties related to income taxes during the nine months ended September 30, 2013 or 2012. The Company did not have an accrual for uncertain tax positions as of September 30, 2013 or December 31, 2012, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2009 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive Income (Loss)

The following table shows the changes in other comprehensive income for the three months ended September 30, 2013 and 2012:

(In thousands)	For the three months ended September 30,					
	2013			2012		
	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Balance, beginning of period			\$ 227			\$ 929
Unrealized holding gains (losses) on securities arising during period	\$ (1,031)	\$ (413)	(618)	\$ 477	\$ 191	286
Less: Reclassification adjustment for gains on securities included in net income	33	11	22	-	-	-
Net unrealized gains (losses) on securities arising during the period	(1,064)	(424)	(640)	477	191	286
Balance, end of period			\$ (413)			\$ 1,215

The following table shows the changes in other comprehensive income for the nine months ended September 30, 2013 and 2012:

(In thousands)	For the nine months ended September 30,					
	2013			2012		
	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Balance, beginning of period			\$ 1,333			\$ 1,121
Unrealized holding gains (losses) on securities arising during period	\$ (2,530)	\$ (1,028)	(1,502)	\$ 665	\$ 234	431
Less: Reclassification adjustment for gains included in net income	367	123	244	507	170	337
Net unrealized gains (losses) on securities arising during the period	(2,897)	(1,151)	(1,746)	158	64	94
Balance, end of period			\$ (413)			\$ 1,215

NOTE 6. Fair Value

Fair Value Measurement

The Company follows FASB ASC Topic 820, “Fair Value Measurement and Disclosures,” which requires additional disclosures about the Company’s assets and liabilities that are measured at fair value. Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company uses various methods including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and/or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company utilizes techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed as follows:

Level 1 Inputs

- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Generally, this includes debt and equity securities and derivative contracts that are traded in an active exchange market (i.e. New York Stock Exchange), as well as certain U.S. Treasury, U.S. Government and sponsored entity agency mortgage-backed securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Inputs

- Quoted prices for similar assets or liabilities in active markets.
- Quoted prices for identical or similar assets or liabilities in inactive markets.
- Inputs other than quoted prices that are observable, either directly or indirectly, for the term of the asset or liability (i.e., interest rates, yield curves, credit risks, prepayment speeds or volatilities) or “market corroborated inputs.”
- Generally, this includes U.S. Government and sponsored entity mortgage-backed securities, corporate debt securities and derivative contracts.

Level 3 Inputs

- Prices or valuation techniques that require inputs that are both unobservable (i.e. supported by little or no market activity) and that are significant to the fair value of the assets or liabilities.
- These assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair Value on a Recurring Basis

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis:

Securities Available for Sale

The fair value of available for sale ("AFS") securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

As of September 30, 2013, the fair value of the Company's AFS securities portfolio was \$80.9 million. Approximately 54 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of \$43.7 million at September 30, 2013. Approximately \$42.4 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States.

All of the Company's AFS securities, excluding commercial mortgage-backed securities, were classified as Level 2 assets at September 30, 2013. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

For Commercial Mortgage-Backed Securities, the inputs used by either dealer market participants or an independent pricing service, may be derived from unobservable market information (Level 3 inputs). In these instances, management evaluates the appropriateness and quality of the assumptions and the resulting prices. In addition, management reviews the volume and level of activity for all AFS securities and attempts to identify transactions which may not be orderly or reflective of a significant level of activity and volume. For securities meeting these criteria, the quoted prices received from either market participants or an independent pricing service may be adjusted, as necessary, to estimate fair value and this results in fair values based on Level 3 inputs. In determining fair value, the Company utilizes unobservable inputs which reflect its own assumptions about the inputs that market participants would use in pricing each security. In developing its assertion of market participant assumptions, the Company utilizes the best information that is both reasonable and available without undue cost and effort.

In calculating the fair value for AFS securities under Level 3, management prepared present value cash flow models for certain private label commercial mortgage-backed securities. Private label commercial mortgage-backed securities

owned by the Bank are A1 and A2 tranche sequential structures and are currently paying principal. The cash flows for the commercial mortgage-backed securities incorporated the expected cash flow of each security adjusted for default rates, loss severities and prepayments of the individual loans collateralizing the security. The following table presents quantitative information about Level 3 inputs used to measure the fair value of commercial mortgage-backed securities at September 30, 2013:

September 30, 2013

Valuation Technique	Unobservable Input	Range	Weighted Average	
Discounted Cash Flow	Prepayment rate	8 through 15	% 10.0	%
	Default rate	10 through 15	% 12.5	%
	Loss severity	10 through 25	% 18.0	%

Significant increases or decreases in any of the unobservable inputs in the table above in isolation would result in a significantly lower or higher fair value measurement of the securities. Generally, a change in the assumption used for the default rate is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

For the Level 3 available for sale private label commercial mortgage-backed securities, cash flow assumptions incorporate independent third party market participant data based on vintage year for each security. The discount rate utilized in determining the present value of cash flows for the commercial mortgage-backed securities was arrived at by combining the yield on orderly transactions for similar maturity government sponsored mortgage-backed securities with (i) the historical average risk premium of similar structured private label securities, (ii) a risk premium reflecting current market conditions, including liquidity risk and (iii) if applicable, a forecasted loss premium derived from the expected cash flows of each security. The estimated cash flows for each private label commercial mortgage-backed security are then discounted at the aforementioned effective rate to determine the fair value. The quoted prices received from either market participants or independent pricing services are weighted with the internal price estimate to determine the fair value of each instrument.

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There were no changes in the inputs or methodologies used to determine fair value during the period ended September 30, 2013, as compared to the periods ended December 31, 2012 and September 30, 2012.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012:

(In thousands)	September 30, 2013			
	Level 1	Level 2	Level 3	Total
Securities available for sale:				
U.S. Government sponsored entities	\$ -	\$ 6,379	\$ -	\$ 6,379
State and political subdivisions	-	16,614	-	16,614
Residential mortgage-backed securities	-	43,669	-	43,669
Commercial mortgage-backed securities	-	-	1,308	1,308
Corporate and other securities	-	12,956	-	12,956
Total securities available for sale	\$ -	\$ 79,618	\$ 1,308	\$ 80,926

(In thousands)	December 31, 2012			
	Level 1	Level 2	Level 3	Total
Securities available for sale:				
U.S. Government sponsored entities	\$ -	\$ 2,568	\$ -	\$ 2,568
State and political subdivisions	-	15,303	-	15,303
Residential mortgage-backed securities	-	45,545	-	45,545
Commercial mortgage-backed securities	-	-	4,463	4,463
Corporate and other securities	-	21,659	-	21,659
Total securities available for sale	\$ -	\$ 85,075	\$ 4,463	\$ 89,538

The following table summarizes changes in Level 3 assets during the three and nine months ended September 30, 2013 and 2012, consisting of commercial mortgage-backed available for sale securities, measured at fair value on a recurring basis:

(In thousands)	For the three months ended		For the nine months ended	
	September 30, 2013	2012	September 30, 2013	2012
Commercial mortgage-backed securities:				
Balance, beginning of period	\$ 1,594	\$ -	\$ 4,463	\$ -
Payoffs	(75)	-	(815)	-

Principal paydowns	(219)	-	(2,301)	-
Total net losses included in:				
Other comprehensive income	8	-	(39)	-
Balance, end of period	\$ 1,308	\$ -	\$ 1,308	\$ -

There were no gains or losses (realized or unrealized) on Level 3 securities included in earnings for assets and liabilities held at September 30, 2013 or 2012.

Fair Value on a Nonrecurring Basis

Certain assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following is a description of the valuation methodologies used for instruments measured at fair value on a nonrecurring basis:

Appraisal Policy

All appraisals must be performed in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"). Appraisals are certified to the Company and performed by appraisers on the Company's approved list of appraisers. Evaluations are completed by a person independent of Company management. The content of the appraisal depends on the complexity of the property. Appraisals are completed on a "retail value" and an "as is value".

The Company requires current real estate appraisals on all loans that become OREO or in-substance foreclosure, loans that are classified substandard, doubtful or loss, or loans that are over \$100,000 and nonperforming. Prior to each balance sheet date, the Company values impaired collateral-dependent loans and OREO based upon a third party appraisal, broker's price opinion, drive by appraisal, automated valuation model, updated market evaluation, or a combination of these methods. The amount is discounted for the decline in market real estate values (for original appraisals), for any known damage or repair costs, and for selling and closing costs. The amount of the discount ranges from 10 to 25 percent and is dependent upon the method used to determine the original value. The original appraisal is generally used when a loan is first determined to be impaired. When applying the discount, the Company takes into consideration when the appraisal was performed, the collateral's location, the type of collateral, any known damage to the property and the type of business. Subsequent to entering impaired status and the Company determining that there is a collateral shortfall, the Company will generally, depending on the type of collateral, order a third party appraisal, broker's price opinion, automated valuation model or updated market evaluation. Subsequent to receiving the third party results, the Company will discount the value 8 to 10 percent for selling and closing costs.

Other Real Estate Owned ("OREO")

The fair value of OREO is determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

Impaired Collateral-Dependent Loans

The fair value of impaired collateral-dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral. Partially charged-off loans are measured for impairment based upon an appraisal for collateral-dependant loans. When an updated appraisal is received for a nonperforming loan, the value on the appraisal is discounted in the manner discussed above. If there is a deficiency in the value after the Company applies these discounts, management applies a specific reserve and the loan remains in nonaccrual status. The receipt of an updated appraisal would not qualify as a reason to put a loan back into accruing status. The Company removes loans from nonaccrual status when the borrower makes nine months of contractual payments and demonstrates the ability to service the debt going forward. Charge-offs are determined based upon the loss that management believes the Company will incur after evaluating collateral for impairment based upon the valuation methods described above and the ability of the borrower to pay any deficiency.

The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At September 30, 2013, the valuation allowance for impaired loans was \$1.4 million, a decrease of \$554 thousand from \$2.0 million at December 31, 2012.

The following tables present the assets and liabilities carried on the balance sheet by caption and by level within the hierarchy (as described above) as of September 30, 2013 and September 30, 2012 and the fair value gains (losses) recognized during the three and nine months ended September 30, 2013 and 2012:

(In thousands)	Fair value at September 30, 2013				Gains (losses) from fair value changes for the three months ended September 30, 2013	Gains (losses) from fair value changes for the nine months ended September 30, 2013
	Level 1	Level 2	Level 3	Total		
Financial assets:						
OREO	\$ -	\$ -	\$ 1,000	\$ 1,000	\$ (390)	\$ (459)
Impaired collateral-dependent loans	-	-	8,782	8,782	286	554

(In thousands)	Fair value at September 30, 2012				Gains (losses) from fair value changes for the three months ended September 30, 2012	Gains (losses) from fair value changes for the nine months ended September 30, 2012
	Level 1	Level 2	Level 3	Total		
Financial assets:						
OREO	\$ -	\$ -	\$ 281	\$ 281	\$ (362)	\$ (1,502)
Impaired collateral-dependent loans	-	-	12,162	12,162	1,320	2,067

Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of September 30, 2013 and December 31, 2012 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents

For these short-term instruments, the carrying value is a reasonable estimate of fair value.

Securities Held to Maturity

The fair value of held to maturity ("HTM") securities is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

SBA Loans Held for Sale

The fair value of SBA loans held for sale is estimated by using a market approach that includes significant other observable inputs.

Loans

The fair value of loans is estimated by discounting the future cash flows using current market rates that reflect the interest rate risk inherent in the loan, except for previously discussed impaired loans.

Federal Home Loan Bank Stock

Federal Home Loan Bank stock is carried at cost. Carrying value approximates fair value based on the redemption provisions of the issues.

SBA Servicing Assets

SBA servicing assets do not trade in an active, open market with readily observable prices. The Company estimates the fair value of SBA servicing assets using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including market discount rates and prepayment speeds.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Deposit Liabilities

The fair value of demand deposits and savings accounts is the amount payable on demand at the reporting date (i.e. carrying value). The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using current market rates.

Borrowed Funds and Subordinated Debentures

The fair value of borrowings is estimated by discounting the projected future cash flows using current market rates.

Standby Letters of Credit

At September 30, 2013, the Bank had standby letters of credit outstanding of \$1.6 million, consistent with December 31, 2012. The fair value of these commitments is nominal.

The table below presents the carrying amount and estimated fair values of the Company's financial instruments not previously presented as of September 30, 2013 and December 31, 2012:

(In thousands)	Fair value level	September 30, 2013		December 31, 2012	
		Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 74,726	\$ 74,726	\$ 94,192	\$ 94,192
Securities held to maturity (1)	Level 2	25,980	25,261	21,515	22,741
SBA loans held for sale	Level 2	5,893	6,376	6,937	7,582
Loans, net of allowance for loan losses (2)	Level 2	641,174	631,628	565,341	564,528
Federal Home Loan Bank stock	Level 2	3,952	3,952	3,989	3,989
SBA servicing assets	Level 3	383	383	396	396
Accrued interest receivable	Level 2	3,131	3,131	3,298	3,298
Financial liabilities:					
Deposits	Level 2	727,112	727,374	648,760	650,668
Borrowed funds and subordinated debentures	Level 2	90,465	98,490	90,465	100,257
Accrued interest payable	Level 2	430	430	434	434

- (1) Includes held to maturity commercial mortgage-backed securities that are considered Level 3. These securities had book values of \$6.8 million and \$2.7 million at September 30, 2013 and December 31, 2012, respectively, and market values of \$6.5 million and \$3.2 million at September 30, 2013 and December 31, 2012, respectively.
- (2) Includes collateral-dependent impaired loans that are considered Level 3 and reported separately in the tables under the "Fair Value on a Nonrecurring Basis" heading. Collateral-dependent impaired loans, net of specific reserves totaled \$8.8 million and \$8.2 million at September 30, 2013 and December 31, 2012, respectively.

NOTE 7. Securities

This table provides the major components of securities available for sale (“AFS”) and held to maturity (“HTM”) at amortized cost and estimated fair value at September 30, 2013 and December 31, 2012:

(In thousands)	September 30, 2013				December 31, 2012			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Available for sale:								
U.S. Government sponsored entities	\$ 6,748	\$ 28	\$ (397)	\$ 6,379	\$ 2,482	\$ 86	\$ -	\$ 2,568
State and political subdivisions	17,027	171	(584)	16,614	14,690	613	-	15,303
Residential mortgage-backed securities	43,269	817	(417)	43,669	43,984	1,684	(123)	45,545
Commercial mortgage-backed securities	1,307	4	(3)	1,308	4,423	42	(2)	4,463
Corporate and other securities	13,255	66	(365)	12,956	21,741	490	(572)	21,659
Total securities available for sale	\$ 81,606	\$ 1,086	\$ (1,766)	\$ 80,926	\$ 87,320	\$ 2,915	\$ (697)	\$ 89,538
Held to maturity:								
U.S. Government sponsored entities	\$ 5,928	\$ -	\$ (462)	\$ 5,466	\$ 5,050	\$ 38	\$ -	\$ 5,088
State and political subdivisions	2,443	114	(20)	2,537	2,746	288	-	3,034
Residential mortgage-backed securities	9,848	171	(150)	9,869	11,048	374	(13)	11,409
Commercial mortgage-backed securities	6,781	99	(391)	6,489	2,671	539	-	3,210
Corporate and other securities	980	-	(80)	900	-	-	-	-
Total securities held to maturity	\$ 25,980	\$ 384	\$ (1,103)	\$ 25,261	\$ 21,515	\$ 1,239	\$ (13)	\$ 22,741

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at September 30, 2013 is distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls.

(In thousands, except percentages)	Within one year		After one through five years		After five through ten years		After ten years		Total carrying value	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale at fair value:										
U.S. Government sponsored entities	\$ 35	3.96 %	\$ 1,015	1.00 %	\$ 942	2.06 %	\$ 4,387	2.19 %	\$ 6,379	1.99 %
State and political subdivisions	-	-	823	2.56	11,442	2.69	4,349	2.80	16,614	2.71
Residential mortgage-backed securities	5	2.59	557	4.47	714	3.27	42,393	2.67	43,669	2.70
Commercial mortgage-backed securities	-	-	-	-	-	-	1,308	2.45	1,308	2.45
Corporate and other securities	-	-	402	1.28	5,709	1.85	6,845	2.49	12,956	2.17
Total securities available for sale	\$ 40	3.78 %	\$ 2,797	2.19 %	\$ 18,807	2.43 %	\$ 59,282	2.62 %	\$ 80,926	2.56 %
Held to maturity at cost:										
U.S. Government sponsored entities	\$ -	- %	\$ -	- %	\$ -	- %	\$ 5,928	1.97 %	\$ 5,928	1.97 %
State and political subdivisions	326	0.75	-	-	-	-	2,117	4.70	2,443	4.17
Residential mortgage-backed securities	5	2.88	786	4.74	370	4.93	8,687	2.83	9,848	3.06
Commercial mortgage-backed securities	-	-	-	-	-	-	6,781	3.80	6,781	3.80
Corporate and other securities	-	-	-	-	980	2.95	-	-	980	2.95
Total securities held to maturity	\$ 331	0.78 %	\$ 786	4.74 %	\$ 1,350	3.49 %	\$ 23,513	3.06 %	\$ 25,980	3.10 %

