ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
November 09, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 - Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011

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 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Commonwealth of Pennsylvania	**23-2530374.**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
77 East King Street, P.O. Box 250, Shippensburg, Pennsylvania	**17257**
(Address of principal executive offices)	**(Zip Code)**

(717) 532-6114

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filled 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 Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES 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 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	x
Non-accelerated 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 x

As of November 1, 2011, 8,053,269 shares of common stock, no par value, of the registrant were outstanding.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

Consolidated Balance Sheets (Unaudited)

(Dollars in Thousands, Except per Share Data)	**September 30, 2011**	December 31, 2010
Assets		
Cash and due from banks	**$ 16,233**	$ 10,400
Federal funds sold	**0**	8,800
Cash and cash equivalents	**16,233**	19,200
Short-term investments	**248**	2,728
Interest bearing deposits with banks	**65,398**	925
Restricted investments in bank stock	**9,757**	8,798
Securities available for sale	**354,042**	431,772
Loans held for sale	**7,470**	2,693
Loans	**989,018**	964,293
Less: Allowance for loan losses	**(25,677)**	(16,020)
Net loans	**970,811**	950,966
Premises and equipment, net	**27,125**	27,774
Cash surrender value of life insurance	**23,903**	22,649
Goodwill and intangible assets	**20,541**	20,698
Accrued interest receivable	**5,172**	5,715
Other assets	**24,085**	20,497
Total assets	**$ 1,517,315**	$ 1,511,722
Liabilities		
Deposits:		
Non-interest bearing	**$ 116,839**	$ 104,646
Interest bearing	**1,170,062**	1,083,731
Total deposits	**1,286,901**	1,188,377
Short-term borrowings	**27,534**	87,850
Long-term debt	**34,120**	65,178
Accrued interest and other liabilities	**9,589**	9,833
Total liabilities	**1,358,144**	1,351,238
Shareholder s Equity		
Preferred stock $1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding	**0**	0

Common stock, no par value - $0.05205 stated value per share; 50,000,000 shares authorized; 8,041,067 and 7,986,966 shares issued; 8,040,255 and 7,985,667 shares outstanding	**419**	416
Additional paid-in capital	**122,324**	121,508
Retained earnings	**30,676**	38,680
Accumulated other comprehensive income (loss)	**5,772**	(88)
Treasury stock - common, 812 and 1,299 shares, at cost	**(20)**	(32)
Total shareholders equity	**159,171**	160,484
Total liabilities and shareholders equity	**$ 1,517,315**	$ 1,511,722

The Notes to Consolidated Financial Statements are an integral part of these statements.

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ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

Consolidated Statements of Operations (Unaudited)

	Three Months Ended	
(Dollars in Thousands, Except per Share Data)	**September 30, 2011**	**September 30, 2010**
Interest and dividend income		
Interest and fees on loans	**$ 12,406**	$ 12,122
Interest and dividends on investment securities		
Taxable	**2,287**	2,016
Tax-exempt	**756**	611
Short term investments	**42**	31
Total interest and dividend income	**15,491**	14,780
Interest expense		
Interest on deposits	**2,322**	2,645
Interest on short-term borrowings	**68**	95
Interest on long-term debt	**276**	372
Total interest expense	**2,666**	3,112
Net interest income	**12,825**	11,668
Provision for loan losses	**7,900**	1,130
Net interest income after provision for loan losses	**4,925**	10,538
Other income		
Service charges on deposit accounts	**1,674**	1,682
Other service charges, commissions and fees	**323**	666
Trust department income	**1,046**	964
Brokerage income	**372**	358
Mortgage banking revenues	**927**	706
Earnings on life insurance	**256**	279
Merchant processing revenues	**1,310**	297
Other income	**692**	(7)
Investment securities gains	**2,351**	1,074
Total other income	**8,951**	6,019
Other expenses		
Salaries and employee benefits	**4,690**	5,011
Occupancy and equipment	**477**	506
Furniture and equipment	**672**	720
Data processing	**375**	319
Telephone	**141**	189
Advertising and bank promotions	**276**	384
FDIC insurance	**690**	305
Professional services	**1,125**	122
Taxes other than income	**226**	238
Intangible asset amortization	**52**	59

Other operating expense	**2,103**	1,662
Total other expenses	**10,827**	9,515
Income before income tax (benefit)	**3,049**	7,042
Income tax expense (benefit)	**(1,265)**	2,146
Net income	**$ 4,314**	$ 4,896
Per share information:		
Basic earnings per share	**$ 0.54**	$ 0.61
Diluted earnings per share	**0.54**	0.61
Dividends per share	**0.23**	0.225
Average shares and common stock equivalents outstanding	**8,026,925**	7,990,735

The Notes to Consolidated Financial Statements are an integral part of these statements

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ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

Consolidated Statements of Operations (Unaudited)

(Dollars in Thousands, Except per Share Data)	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Interest and dividend income		
Interest and fees on loans	**$ 37,224**	$ 36,166
Interest and dividends on investment securities		
Taxable	**6,746**	5,452
Tax-exempt	**2,296**	1,387
Short term investments	**87**	94
Total interest and dividend income	**46,353**	43,099
Interest expense		
Interest on deposits	**7,206**	8,072
Interest on short-term borrowings	**286**	340
Interest on long-term debt	**838**	1,222
Total interest expense	**8,330**	9,634
Net interest income	**38,023**	33,465
Provision for loan losses	**32,325**	7,550
Net interest income after provision for loan losses	**5,698**	25,915
Other income		
Service charges on deposit accounts	**4,804**	4,715
Other service charges, commissions and fees	**1,020**	1,696
Trust department income	**3,092**	2,629
Brokerage income	**1,260**	1,101
Mortgage banking revenues	**2,259**	1,731
Earnings on life insurance	**836**	884
Merchant processing revenues	**1,850**	842
Other income	**916**	1,000
Investment securities gains	**3,199**	3,253
Total other income	**19,236**	17,851
Other expenses		
Salaries and employee benefits	**13,698**	14,087
Occupancy and equipment	**1,516**	1,540
Furniture and equipment	**2,045**	1,980
Data processing	**1,036**	922
Telephone	**482**	545
Advertising and bank promotions	**830**	795
FDIC insurance	**2,002**	1,139
Professional services	**1,993**	569
Taxes other than income	**636**	587
Intangible asset amortization	**157**	187

Other operating expense	**5,593**	4,345
Total other expense	**29,988**	26,696
Income (loss) before income tax (benefit)	**(5,054)**	17,070
Income tax expense (benefit)	**(2,572)**	4,864
Net income (loss)	**$ (2,482)**	$ 12,206
Per share information:		
Basic earnings (loss) per share	**$ (0.31)**	$ 1.62
Diluted earnings (loss) per share	**(0.31)**	1.62
Dividends per share	**0.69**	0.665
Average shares and common stock equivalents outstanding	**8,017,550**	7,510,469

The Notes to Consolidated Financial Statements are an integral part of these statements

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ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

Consolidated Statements of Changes in Shareholders Equity (Unaudited)

	Nine Months Ended September 30, 2011 and 2010					
(Dollars in thousands)	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance, January 1, 2010	$ 337	$ 82,895	$ 28,857	($ 501)	($ 702)	$ 110,886
Comprehensive income						
Net income	0	0	12,206	0	0	12,206
Net unrealized securities gains	0	0	0	5,806	0	5,806
Net unrealized gains on derivatives	0	0	0	824	0	824
Comprehensive income						18,836
Cash dividends ($0.665 per share)	0	0	(4,961)	0	0	(4,961)
Stock-based compensation plans:						
Compensation expense	0	378	0	0	0	378
Issuance of stock	0	150	0	0	0	150
Issuance of stock through dividend reinvestment plan	2	666	0	0	0	668
Purchase of treasury stock (9,109 shares)	0	0	0		(195)	(195)
Issuance of treasury stock (24,474 shares)	0	(63)	0	0	649	586
Proceeds from issuance of common stock (1,481,481 shares)	77	37,508	0	0	0	37,585
Balance, September 30, 2010	$ 416	$ 121,534	$ 36,102	$ 6,129	($ 248)	$ 163,933
Balance, January 1, 2011	**$ 416**	**$ 121,508**	**$ 38,680**	**($ 88)**	**($ 32)**	**$ 160,484**
Comprehensive income						
Net income (loss)	**0**	**0**	**(2,482)**	**0**	**0**	**(2,482)**
Net unrealized securities gains	**0**	**0**	**0**	**6,456**	**0**	**6,456**
Net unrealized losses on derivatives	**0**	**0**	**0**	**(596)**	**0**	**(596)**
Comprehensive income						**3,378**
Cash dividends ($0.69 per share)	**0**	**0**	**(5,522)**	**0**	**0**	**(5,522)**
Stock-based compensation plans:						
Issuance of stock	**1**	**507**	**0**	**0**	**0**	**508**
Issuance of stock through dividend reinvestment plan	**2**	**328**				**330**
Purchase of treasury stock (2,232 shares)	**0**	**0**	**0**	**0**	**(54)**	**(54)**
Issuance of treasury stock (2,719 shares)	**0**	**(19)**	**0**	**0**	**66**	**47**
Balance, September 30, 2011	$ 419	$ 122,324	$ 30,676	$ 5,772	($ 20)	$ 159,171

The Notes to Consolidated Financial Statements are an integral part of these statements

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ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended	
(Dollars in Thousands, Except per Share Data)	**September 30, 2011**	**September 30, 2010**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	**$ (2,482)**	$ 12,206
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	**4,045**	2,470
Depreciation and amortization	**2,055**	2,180
Provision for loan losses	**32,325**	7,550
Net change in loans held for sale	**(4,777)**	(4,986)
Net (gain) loss on disposal of other real estate owned	**(30)**	56
Write-down of other real estate owned	**350**	0
Net (gain) loss on disposal of bank premises and equipment	**2**	(119)
Investment securities gains	**(3,199)**	(3,253)
Gain on sale of rate swap	**(791)**	(778)
Earnings on cash surrender value of life insurance	**(754)**	(864)
Deferred income taxes	**(5,827)**	(2,046)
(Increase) decrease in accrued interest receivable	**543**	(1,398)
Decrease in accrued interest payable	**(106)**	(120)
Other, net	**(568)**	1,924
Net cash provided by operating activities	**20,786**	12,822
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (increase) decrease in interest bearing deposits with banks and short term investments	**(61,993)**	3,674
Sales of available for sale securities	**102,665**	188,403
Maturities, repayments and calls of available for sale securities	**42,674**	42,509
Purchases of available for sale securities	**(58,588)**	(454,062)
Net purchases of restricted investments in bank stocks	**(959)**	(540)
Net increase in loans	**(49,647)**	(40,933)
Investment in limited partnerships	**(254)**	(1,328)
Purchases of bank premises and equipment	**(895)**	(440)
Proceeds from disposal of other real estate owned	**388**	378
Proceeds from disposal of bank premises and equipment	**0**	373
Proceeds from sale of rate swap	**911**	868
Purchases of bank owned life insurance	**(500)**	(1,730)
Redemption of cash surrender value upon death	**0**	1,220
Net cash used by investing activities	**(26,198)**	(261,608)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	**98,510**	223,699
Net increase (decrease) in short term purchased funds	**(60,316)**	26,955
Payments on long-term debt	**(31,058)**	(24,030)
Dividends paid	**(5,522)**	(4,961)
Proceeds from issuance of common stock	**838**	38,403
Purchase of treasury stock	**(54)**	(195)
Net proceeds from issuance of treasury stock	**47**	586
Net cash provided by financing activities	**2,445**	260,457

Net increase (decrease) in cash and cash equivalents	**(2,967)**	11,671
Cash and cash equivalents at beginning of period	**19,200**	21,940
Cash and cash equivalents at end of period	**$ 16,233**	$ 33,611
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	**$ 8,436**	$ 9,754
Income taxes	**3,657**	6,100
Supplemental schedule of noncash investing activities:		
Other real estate acquired in settlement of loans	**$ 2,239**	$ 1,955

The Notes to Consolidated Financial Statements are an integral part of these statements

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ORRSTOWN FINANCIAL SERVICES, INC.

Notes to Consolidated Financial Statements

September 30, 2011

NOTE 1. SUMMARY OF CONSOLIDATED SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations - Orrstown Financial Services, Inc. (the Company) is a financial holding company whose primary activity consists of supervising its wholly-owned subsidiary, Orrstown Bank (the Bank). The Company operates through its office headquartered in Shippensburg, Pennsylvania. Orrstown Bank provides services through its network of offices in Franklin, Cumberland and Perry Counties of Pennsylvania and in Washington County, Maryland. The Bank engages in lending services for commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Deposit services include checking, savings, time and money market deposits. The Bank also provides investment and brokerage services through its Orrstown Financial Advisors division. The Bank has twenty-one branches located in Shippensburg (2), Carlisle (5), Spring Run, Orrstown, Chambersburg (3), Mechanicsburg (2), Camp Hill, Greencastle, Newport (2), Duncannon, and New Bloomfield, Pennsylvania and Hagerstown, Maryland. The Company and its subsidiary are subject to the regulation of certain federal and state agencies and undergo periodic examinations by such regulatory authorities.

Basis of Presentation - The unaudited financial statements of the Company and its subsidiary are presented for the three and nine months ended September 30, 2011 and 2010 and have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. However, the unaudited information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, considered necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2010 is condensed from audited year-end financial statements. For further information, refer to the audited consolidated financial statements and footnotes thereto, included in the annual report on Form 10-K for the year ended December 31, 2010.

All significant intercompany transactions and accounts have been eliminated. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

Use of Estimates - The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements 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 relate to the determination of the allowance for losses on loans and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for losses on loans and foreclosed real estate, management obtains independent appraisals for significant properties.

While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company s allowance for losses on loans and foreclosed real estate. Such agencies may require the Company to recognize additions to the allowance based on their judgments concerning information available to them at the time of their examination. Because of these factors, management s estimate of credit losses inherent in the loan portfolio and the related allowance may change in the near term.

Subsequent Events - GAAP establishes standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The subsequent events principle sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that should be made about events or transactions that occur after the balance sheet date. In preparing these financial statements, the Company evaluated the events and transactions that occurred after September 30, 2011, through the date these financial statements were filed with the Securities and Exchange Commission (the Commission).

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Concentration of Credit Risk - The Company grants agribusiness, commercial, residential and consumer loans to customers in its market area. Although the Company maintains a diversified loan portfolio, a significant portion of its customers ability to honor their contracts is dependent upon economic sectors for construction contractors, residential and non-residential building operators, sales finance, sub-dividers and developers. Management evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained, if collateral is deemed necessary by the Company upon the extension of credit, is based on management s credit evaluation of the customer. Collateral held varies, but generally includes real estate and equipment.

The types of securities the Company invests in are included in Note 2, Securities Available for Sale, and the type of lending the Company engages in are included in Note 3 Loans Receivable and Allowance for Loan Losses.

Cash and Cash Equivalents - For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash, balances due from banks, federal funds sold and interest bearing deposits with banks all of which have original maturities of 90 days or less.

Loans Held for Sale Loans originated and intended for sale in the secondary market are carried at lower of aggregate cost or fair value (LOCM). Gains and losses on loan sales (sales proceeds minus carrying value) are recorded in non-interest income.

Securities - Certain debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. As of the periods presented, the Company has no held to maturity or trading securities. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company follows accounting guidance related to recognition and presentation of other-than-temporary impairment (Financial Accounting Standards Board Accounting Standards Codification FASB ASC 320-10). This accounting guidance specifies that (*a*) if a company does not have the intent to sell a debt security prior to recovery and (*b*) it is more likely than not that it will not have to sell the debt security prior to recovery; the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

The Company had no debt securities it deemed to be other than temporarily impaired for the periods presented.

The Company s securities are exposed to various risks, such as interest rate, market risk, currency and credit risks. Due to the level of risk associated with certain investments and the level of uncertainty related to changes in the value of investments, it is at least reasonably possible that changes in risks in the near term would materially affect investment assets reported in the consolidated financial statements.

For equity securities, when the Company has decided to sell an impaired available-for-sale security and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made.

Loans - The Company grants commercial, mortgage, and consumer loans to its customers located principally in south-central Pennsylvania and northern Maryland. The ability of the Company s debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and amortized as a yield adjustment over the respective term of the loan.

For all classes of loans, the accrual of interest income on loans, including impaired loans, ceases when principal or interest is past due 90 days or more or immediately if, in the opinion of management, full collection is unlikely.

Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, as of the date of placement on nonaccrual status, is reversed and charged against current interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending upon management s assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, has performed in accordance with the contractual terms of the note for a reasonable period of time, generally nine months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contractual terms of the loan for all loan classes.

Loans the terms of which are modified are classified as troubled debt restructurings if a concession was granted, for legal or economic reasons, related to a debtor s financial difficulties. Concessions granted under a troubled debt restructuring typically involve a temporary deferral of scheduled loan payments, an extension of a loan s stated maturity date, temporary reduction in interest rates, or below market rates. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual troubled debt restructurings are restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for nine months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. Troubled debt restructurings are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms.

Allowance for Loan Losses - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

See Note 3, Loans Receivable and Allowance for Loan Losses, for additional details.

Stock Compensation Plans - The Company has stock option plans for its employees and non-employee directors. Stock compensation accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is measured based on the grant date fair value of the stock options, using a Black-Scholes model. Compensation cost for all stock awards are calculated and recognized over the employees service period, generally defined as the vesting period.

Income Taxes - The Company accounts for income taxes in accordance with income tax accounting guidance (FASB ASC 740, *Income Taxes*). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. For interim financial reporting, the Company computes its income tax expense (benefit) based on its estimated annual effective tax rate for the year, as noted in FASB ASC 740-270-25.

Earnings Per Share - Basic earnings (loss) per share represent income (loss) available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share reflect the additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate solely to outstanding stock options. Treasury shares are not deemed outstanding for earnings per share calculations.

Comprehensive Income - Comprehensive income (loss) consists of net income (loss) and other comprehensive income. Other comprehensive income includes unrealized gains on securities available for sale, and unrealized losses related to factors other than credit on debt securities and unrealized gains and losses on cash flow hedges.

Derivative Instruments - GAAP requires that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the dates that derivative contracts are entered into,

the Company designates derivatives as (a) hedges of fair values of recognized assets or liabilities or of unrecognized firm commitments (fair-value hedges); (b) hedges of forecasted transactions or variable cash flows to be received or paid in conjunction with recognized assets or liabilities (cash-flow hedges) or (c) instruments that are held for trading or non-hedging purposes (trading or economic-hedging instruments). For a derivative treated as a fair-value hedge, the effective portion of a change in fair value is recorded as an adjustment to the hedged item. The ineffective portion of the fair-value hedge is recognized in current period earnings. Upon termination of a fair-value hedge of a debt instrument, the resulting gain or loss is amortized to earnings through the maturity date of the debt instrument. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is reported in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income. For a derivative treated as a trading or economic hedging instrument, changes in fair value are reported in current period earnings. Fair values are determined based upon quoted market prices and mathematical models using current and historical data.

The Company formally assesses, both at the hedges inception, and on an on-going basis, whether derivatives used in hedging transactions have been highly effective in offsetting changes in fair values or cash flows of hedged items and whether those derivatives are expected to remain highly effective in subsequent periods. The Company discontinues hedge accounting when (a) it determines that a derivative is no longer effective in offsetting changes in fair value or cash flows of a hedged item; (b) the derivative expires or is sold, terminated or exercised; (c) probability exists that the forecasted transaction will no longer occur or (d) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all cases in which hedge accounting is discontinued and a derivative remains outstanding, the Company will carry the derivative at fair value in the Consolidated Financial Statements, recognizing changes in fair value in current period income in the statement of income.

The Company follows GAAP, regarding disclosures about derivative instruments and hedging activities, which includes disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows.

Segment Reporting - The Company only operates in one significant segment Community Banking. The Company s non-banking activities are insignificant to the consolidated financial statements.

Reclassifications Certain amounts in the 2010 consolidated financial statements have been reclassified to conform to the 2011 presentation.

Recent Accounting Pronouncements - In January 2010, the FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 was effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures were effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The new disclosure guidance significantly expanded the existing requirements leading to greater transparency into the company s exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period was effective for annual reporting periods ending on or after December 15, 2010 and has been presented in Note 3 to the Consolidated Financial Statements. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures was required to be adopted for periods beginning on or after December 15, 2010, and are also incorporated in Note 3.

In December 2010, the FASB issued ASU 2010-28, Intangibles *Goodwill and Other (Topic 350), When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts.* ASU 2010-28 affects all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. ASU 2010-28 modifies Step 1 so that for those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. The qualitative factors are consistent with existing guidance, which requires

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that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This guidance is effective for the Company for fiscal years, and interim periods within those years, beginning after December 15, 2010. Adoption of ASU 2010-28 guidance did not have a material impact on the Company s consolidated financial statements.

In April 2011, the FASB issued ASU 2011-2, A *Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring*. This guidance clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for the purpose of recording an impairment charge and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-2, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. As allowed by the guidance, the Company adopted the provisions of ASU 2011-2 in the quarter ending June 30, 2011. See further discussion in Note 3 Loans Receivable and Allowance for Loan Losses.

In June 2011, the FASB issued ASU 2011-5, *Presentation of Comprehensive Income*. This guidance amends existing guidance to improve the comparability of financial reporting and to increase the prominence of items reported in other comprehensive income. The guidance eliminated the option to present components of other comprehensive income as part of the changes in shareholders equity and requires all changes in shareholders equity to be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance also requires entities to present all reclassification adjustments from other comprehensive income to net income on the face of the financial statements. The guidance did not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The guidance is effective for fiscal years and interim periods within those years, beginning after December 15, 2011, and early adoption is permitted. The Company does not anticipate the adoption of ASU 2011-5 will have a material impact on the Company s consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, *Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment.* ASU 2011-08 allows companies to assess qualitative factors to determine if it is more-likely-than-not that goodwill might be impaired whether it is necessary to perform the two-step goodwill impairment test required under current accounting standards. This guidance is effective for fiscal years beginning after December 15, 2011, and early adoption is permitted. The Company is currently evaluating this guidance, but does not expect the adoption will have a material effect on its consolidated financial statements.

NOTE 2. SECURITIES AVAILABLE FOR SALE

At September 30, 2011 and December 31, 2010, the investment securities portfolio was comprised exclusively of securities classified as available for sale , resulting in investment securities being carried at fair value. The amortized cost and fair values of investment securities available for sale at September 30, 2011 and December 31, 2010 were as follows:

(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2011				
U.S. Government Sponsored Enterprises (GSE)	**$ 64,085**	**$ 3,955**	**$ 0**	**$ 68,040**
States and political subdivisions	**88,546**	**2,440**	**73**	**90,913**
GSE residential mortgage-backed securities	**190,385**	**3,002**	**93**	**193,294**
Total debt securities	**343,016**	**9,397**	**166**	**352,247**
Equity securities	**2,146**	**29**	**380**	**1,795**
Totals	**$ 345,162**	**$ 9,426**	**$ 546**	**$ 354,042**
December 31, 2010				
U.S. Government Sponsored Enterprises (GSE)	$ 120,318	$ 1,491	$ 1,523	$ 120,286
States and political subdivisions	98,133	566	1,551	97,148
GSE residential mortgage-backed securities	212,260	960	1,044	212,176

Total debt securities	430,711	3,017	4,118	429,610
Equity securities	2,114	93	45	2,162
Totals	$ 432,825	$ 3,110	$ 4,163	$ 431,772

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The following table shows gross unrealized losses and fair value of the Company s available for sale securities that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2011 and December 31, 2010:

	Less than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2011						
U.S. Government Sponsored Enterprises (GSE)	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 0**	**$ 0**
States and political subdivisions	**4,447**	**6**	**615**	**67**	**5,062**	**73**
GSE residential mortgage-backed securities	**24,026**	**93**	**0**	**0**	**24,026**	**93**
Total debt securities	**28,473**	**99**	**615**	**67**	**29,088**	**165**
Equity securities	**1,482**	**379**	**5**	**1**	**1,487**	**380**
Total temporarily impaired securities	**$ 29,955**	**$ 478**	**$ 620**	**$ 68**	**$ 30,575**	**$ 546**
December 31, 2010						
GSE s	$ 44,737	$ 1,523	$ 0	$ 0	$ 44,737	$ 1,523
States and political subdivisions	61,718	1,303	1,026	248	62,744	1,551
GSE residential mortgage-backed securities	124,685	1,044	0	0	124,685	1,044
Total debt securities	231,140	3,870	1,026	248	232,166	4,118
Equity securities	312	12	312	33	624	45
Total temporarily impaired securities	$ 231,452	$ 3,882	$ 1,338	$ 281	$ 232,790	$ 4,163

The Company had 50 securities and 126 securities at September 30, 2011 and December 31, 2010, respectively, in which the amortized cost exceeds their fair values, as discussed below.

U.S. Government Sponsored Enterprises (GSE). Seven GSE securities, including mortgage-backed securities, have amortized costs which exceed their fair values, all of which are in the less than 12 months category at September 30, 2011. At December 31, 2010, the Company had 50 GSE securities with unrealized losses, all of which were in the less than 12 months category. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2011 or at December 31, 2010.

State and Political Subdivisions. Five state and political subdivision securities have amortized costs which exceed their fair value, including 1 of which has been for greater than 12 months at September 30, 2011. At December 31, 2010, 63 state and political subdivision securities had unrealized losses, 3 of which were greater than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. The security which has had an unrealized loss for over 24 months at September 30, 2011 is a California issue that is carrying a low market value due to it being a zero coupon bond, which is hindered by the state s economic issues, and not the underlying credit worthiness of the issuer. This security carries an investment grade rating. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2011 or at December 31, 2010.

Equity Securities. Thirty-eight equity securities have cost which exceeds their fair value, including 1 of which has been greater than 12 month at September 30, 2011. At December 31, 2010, 13 equity securities had unrealized losses, of which 7 had unrealized losses for greater than 12 months. These securities encompass various industries, including financial, industrial, consumer, energy, health care and a large cap fund, In considering whether the equity securities are other-than-temporarily impaired, management reviews the severity and duration of decline in fair value, research reports, analysts recommendations, credit rating changes, news stories and other relevant information. Management believes the equity securities are not other-than-temporarily impaired and their fair values will equal or exceed our cost bases within a reasonable period of time. Since these companies are considered viable and carry the possibility of price appreciation in the future, impairments are considered temporary. The Company recorded no other than temporary impairment expense on equity securities for the quarters or nine months ended September 30, 2011 and 2010.

The amortized cost and fair values of securities available for sale at September 30, 2011 by contractual maturity are shown below. Contractual maturities will differ from expected maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale	
(Dollars in thousands)	**Amortized Cost**	**Fair Value**
Due in one year or less	**$ 4,500**	**$ 4,524**
Due after one year through five years	**12,726**	**13,022**
Due after five years through ten years	**68,681**	**72,620**
Due after ten years	**66,724**	**68,787**
GSE residential mortgage-backed securities	**190,385**	**193,294**
Total debt securities	**343,016**	**352,247**
Equity securities	**2,146**	**1,795**
	$ 345,162	**$ 354,042**

Proceeds from sales of securities available for sale for the three months ended September 30, 2011 and 2010 were $65,986,000 and $30,784,000. Gross gains on the sales of securities were $2,373,000 and $1,141,000 for the three months ended September 30, 2011 and 2010. Gross losses on securities available for sale were $22,000 and $67,000 for the three months ended September 30, 2011 and 2010.

Proceeds from sales of securities available for sale for the nine months ended September 30, 2011 and 2010 were $102,665,000 and $188,403,000. Gross gains on the sales of securities were $3,294,000 and $3,641,000 for the nine months ended September 30, 2011 and 2010. Gross losses on securities available for sale were $95,000 and $388,000 for the nine months ended September 30, 2011 and 2010.

Securities with a fair value of $305,182,000 and $271,689,000 at September 30, 2011 and December 31, 2010 were pledged to secure public funds and for other purposes as required or permitted by law.

NOTE 3. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The Bank s loan portfolio is broken down into segments to an appropriate level of disaggregation to allow management to monitor the performance by the borrower and to monitor the yield on the portfolio. In 2010, management incorporated the provisions of ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses,* resulting in a refinement in its portfolio segregation. Consistent with the standard, the segments were further broken down into classes, to allow for differing risk characteristics within a segment.

The risks associated with lending activities differ among the various loan classes, and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans, and general economic conditions. All of these factors may adversely impact the borrower s ability to repay its loans, and impact the associated collateral.

The Company makes various types of commercial real estate loans which have differing levels of credit risk associated with them. Owner-occupied commercial real estate loans are generally dependent upon the successful operation of the borrowers business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower s ability to repay the loan could be in jeopardy. In order to minimize this credit risk, the Company has conservative underwriting standards which include the credit worthiness of the borrower, a limitation on loan amounts to 75% of the value of the property securing the loan, and strong debt service coverage ratios.

Non-owner occupied and multi-family commercial real estate loans present a different credit risk to the Company than owner-occupied commercial real estate, as the repayment of the loan is dependent upon the borrower s ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirement and operating expenses. Lower occupancy or lease rates may result in reduction in cash flows, which hinder the ability of the borrower to meet debt service requirements, and may result in lower collateral values. The Company generally follows the same underwriting standards for these loans as with owner-occupied commercial real estate, but recognizes the greater risk inherent in these credit relationships in its loan pricing.

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Acquisition and development loans consist of 1-4 family residential construction and commercial and land development loans. The risk of loss on these loans is largely dependent on the Company s ability to assess the property s value at the completion of the project, which should exceed the property s construction costs. During the construction phase, a number of factors could potentially negatively impact the collateral value, including cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply of similar properties in the area. In the event the collateral value at the completion of the project is not sufficient to cover the outstanding loan balance, the Company must rely upon other repayment sources, including the guarantors of the project or other collateral securing the loan. The Company attempts to mitigate credit risk through strict underwriting standards including evaluation of the credit worthiness of the borrower and their success in other projects, aggressive release fees, loan-to-value ratios not to exceed 75%, and continual monitoring of the project during its construction phase to determine the impact that overruns and delays may have on the project.

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of these loans are secured by the borrower s accounts receivable, inventory and machinery and equipment. In a majority of these loans, the collateral also includes the business real estate or the business owner s personal real estate or assets. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. The Company attempts to mitigate this risk through strict underwriting standards, including evaluating the credit worthiness of the borrower and to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are common. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the credit. The Company s risk exposure is minimized in these types of loans through the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and underwriting standards which limits the loan-to-value ratio to generally no more than 80%, unless the borrower obtains private mortgage insurance.

Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios, which generally cannot exceed 38%.

Installment and other loans credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and if secured, the collateral value of the assets. As these loans can be unsecured or secured by assets the value of which may depreciate quickly or may fluctuate, they present a greater risk to the Company than 1-4 family residential loans.

The loan portfolio, excluding residential loans held for sale, broken out by classes as of September 30, 2011 and December 31, 2010 is as follows:

(Dollars in thousands)	**September 30, 2011**	**December 31, 2010**
Commercial real estate:		
Owner-occupied	$ 199,024	$ 172,000
Non-owner occupied	138,869	143,372
Multi-family	25,937	24,649
Acquisition and development:		
1-4 family residential construction	12,271	29,297
Commercial and land development	96,177	88,105
Commercial and industrial	280,285	263,943
Residential mortgage:		
First lien	105,864	119,450
Home equity - term	39,650	40,818
Home equity - Lines of credit	78,559	71,547
Installment and other loans	12,382	11,112

	$ 989,018	$ 964,293

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In order to monitor ongoing risk associated with its loan portfolio and specific credits within the segments, management uses an eight point internal grading system. The first four rating categories, representing the lowest risk to the Bank, are combined and given a Pass rating. The Special Mention category includes loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Bank s position at some future date. These assets pose elevated risk, but their weakness does not yet justify a more severe, or criticized rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including substandard, doubtful or loss. Substandard loans are classified as they have a well-defined weakness, or weaknesses that jeopardize liquidation of the debt. These loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Substandard loans include loans that management has determined not to be impaired, as well as loans considered to be impaired. A doubtful loan has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification of loss is deferred. Loss assets are considered uncollectible, as the underlying borrowers are often in bankruptcy, have suspended debt repayments, or ceased business operations. Once a loan is classified as Loss , there is little prospect of collecting the loan s principal or interest and it is generally written off.

The Bank has a loan review policy and program which is designed to reduce and control risk in the lending function. The Credit Administration Committee, comprised of members of the Board, is charged with the overall credit quality and risk exposure of the Company s loan portfolio. This includes the monitoring of the lending activities of all bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an internal, independent review of the Bank s loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible credit event.

Loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $750,000, with ratification of the rating from the Board of Directors Credit Administration Committee for loans between $750,000 - $1,000,000. Loans reviewed in excess of $1,000,000 are presented to the Credit Administration Committee with a formal review and rating. All relationships rated Substandard, Doubtful or Loss are reviewed by the Credit Administration Committee on a quarterly basis, including reaffirmation of the rating, review of detailed collateral analysis and the development of an action plan. In addition to the policy guidelines noted above, the Company expanded its review coverage during the second and third quarters of 2011 in light of softness in overall economic conditions and deterioration of underlying collateral securing lending relationships. As a result, all commercial real estate, construction and development loans, and commercial loans in excess of $500,000, representing over 75% coverage of these portfolios, have been reviewed and assigned a loan rating.

The following summarizes the Bank s ratings based on its internal risk rating system as of September 30, 2011 and December 31, 2010:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
September 30, 2011:						
Commercial real estate:						
Owner-occupied	$ 171,163	$ 8,583	$ 10,579	$ 8,080	$ 619	$ 199,024
Non-owner occupied	101,269	12,501	16,426	8,122	551	138,869
Multi-family	19,090	1,268	1,798	3,781	0	25,937
Acquisition and development:						
1-4 family residential construction	7,690	166	4,286	129	0	12,271
Commercial and land development	57,413	12,012	18,997	7,755	0	96,177
Commercial and industrial	205,277	12,412	25,935	36,273	388	280,285
Residential mortgage:						
First lien	104,282	0	1,120	462	0	105,864
Home equity - term	38,743	0	198	709	0	39,650
Home equity - Lines of credit	78,372	0	187	0	0	78,559
Installment and other loans	12,380	0	2	0	0	12,382
	$ 795,679	$ 46,942	$ 79,528	$ 65,311	$ 1,558	$ 989,018

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(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
December 31, 2010						
Commercial real estate:						
Owner-occupied	$ 162,968	$ 2,035	$ 6,311	$ 0	$ 686	$ 172,000
Non-owner occupied	120,633	4,274	15,495	2,970	0	143,372
Multi-family	20,030	676	3,853	0	90	24,649
Acquisition and development:						
1-4 family residential construction	24,199	2,297	2,801	0	0	29,297
Commercial and land development	79,391	2,487	6,134	93	0	88,105
Commercial and industrial	221,111	17,062	14,992	9,770	1,008	263,943
Residential mortgage:						
First lien	117,607	0	1,373	470	0	119,450
Home equity - term	39,279	0	828	711	0	40,818
Home equity - Lines of credit	71,364	0	183	0	0	71,547
Installment and other loans	11,062	0	50	0	0	11,112
	$ 867,644	$ 28,831	$ 52,020	$ 14,014	$ 1,784	$ 964,293

Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are assigned a Substandard rating. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Nonaccrual loans in the commercial and commercial real estate portfolios are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. The updated fair values will be incorporated into the impairment analysis as of the next reporting period. In the event an updated appraisal that requires a higher impairment reserve is received after a reporting period, but prior to the issuance of the financial statements, an evaluation is made as to the significance of the difference and whether the amounts need to be reflected in the financial statements not yet issued.

Loan charge-offs, which may include, from time-to-time, a partial charge-off, are taken on an impaired loan that is collateral dependent if the loan s carrying balance exceeds its collateral s appraised value, the loan has been identified as uncollectible, and it is deemed to be a confirmed loss. Typically, impaired loans with a charge-off or partial charge-off will continue to be considered impaired, unless the note is split into two, and management expects the performing note to continue to perform and is adequately secured. The second, or non-performing note, would be charged-off. As of the periods presented, the Company has no loans to borrowers that resulted from splitting impaired loans into multiple notes. Further, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

As of September 30, 2011 and December 31, 2010, nearly all of the Company s impaired loans extent of impairment was measured based on the estimated fair value of the collateral securing the credit, except for troubled debt restructurings. By definition, troubled debt restructurings are considered impaired, however, nearly all restructured loans impairment was determined based on discounted cash flows. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

At the time a real estate-secured loan is deemed impaired, management determines whether an updated certified appraisal of the real estate is necessary to assist in determining the extent of an impairment reserve, if any. The decision, whether an updated appraisal is required, takes into consideration the age of the most recent appraisal, the loan-to-value ratio based on the original certified appraisal, the Company s recent experience and knowledge of market conditions, recent list prices or broker opinions, the condition of the property, and environmental factors. If market

conditions have changed significantly from the date of the most recent appraisal, an updated appraisal will be obtained. As of October 1, 2011, the Company amended its policy, which now requires annual updated appraisals for criticized loans in excess of $250,000 which will be used for future impairment analysis. The as is value provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

Generally, impaired loans secured by real estate were measured at fair value using certified real estate appraisals that had been completed within the last year. Appraised values are further discounted for estimated costs to sell the property and other selling considerations to arrive at the properties fair value.

In those situations in which it is determined an updated appraisal is not required for loans individually evaluated for impairment, fair values are based on one or a combination of the following approaches. In those situations in which a combination of approaches is considered, the factor that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

Original appraisal - if the original appraisal provides a strong loan-to-value (generally 80% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the loan review staff that there has not been a significant deterioration in the collateral value, the original certified appraised value will be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.

Discounted cash flows - In limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

Collateral on certain impaired loans is not limited to real estate, and may include accounts receivable, inventory, equipment or other business assets. Estimated fair values are determined based on borrowers financial statements, inventory ledgers, accounts receivable agings or appraisals from individuals with knowledge in the business. Stated balances are generally discounted for the age of the financial information or the quality of the assets. In determining fair value, liquidation discounts are applied to this collateral based on existing loan evaluation policies.

The Company distinguishes Substandard loans on both an impaired and non-impaired basis, as it places less emphasis on a loan s classification, and increased reliance on whether the loan was performing in accordance with the contractual terms. Substandard classification does not automatically meet the definition of impaired . A substandard credit is one that is inadequately protected by current sound worth, paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard. As a result, the Company revised its methodology in its evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated substandard collectively for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of substandard , they are generally performing and management has concluded that it is likely it will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement.

Larger groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

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The following summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of September 30, 2011 and December 31, 2010:

	Impaired Loans with a Specific Allowance			Impaired Loans with No Specific Allowance	
(Dollars in thousands)	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)	Related Allowance	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)
September 30, 2011					
Commercial real estate:					
Owner-occupied	$ 1,632	$ 1,632	$ 150	$ 7,067	$ 7,145
Non-owner occupied	7,486	8,376	2,228	1,187	2,291
Multi-family	3,781	5,769	522	0	0
Acquisition and development:					
1-4 family residential construction	129	129	14	0	0
Commercial and land development	6,799	9,506	1,160	956	956
Commercial and industrial	32,039	32,452	3,450	4,622	4,622
Residential mortgage:					
First lien	462	462	4	0	0
Home equity - term	709	709	137	0	0
	$ 53,037	$ 59,035	$ 7,665	$ 13,832	$ 15,014
December 31, 2010					
Commercial real estate:					
Owner-occupied	$ 686	$ 687	$ 181	$ 0	$ 0
Non-owner occupied	2,064	2,065	980	0	0
Multi-family	90	90	90	0	0
Commercial and industrial	9,600	10,191	3,232	1,118	1,118
Residential mortgage:					
First lien	470	470	12	0	0
Home equity - term	711	711	8	0	0
	$ 13,621	$ 14,214	$ 4,503	$ 1,118	$ 1,118

The following summarizes the average recorded investment in impaired loans and related interest income recognized for the three and nine months ended September 30, 2011:

	Three Months Ended		**Nine months Ended**	
(Dollars in thousands)	**Average Impaired Balance**	**Interest Income Recognized**	**Average Impaired Balance**	**Interest Income Recognized**
Commercial real estate:				
Owner-occupied	$ 5,500	$ 38	$ 3,210	$ 236
Non-owner occupied	5,376	90	3,479	335
Multi-family	3,423	14	1,734	207
Acquisition and development:				
1-4 family residential construction	131	1	65	3
Commercial and land development	9,109	36	4,554	244
Commercial and industrial	33,171	351	21,936	1,093
Residential mortgage:				

First lien	463	17	466	23
Home equity - term	710	6	710	10
Total	$ 57,883	$ 553	$ 36,154	$ 2,151

In the second quarter of 2011, the Company early adopted the provisions of ASU No. 2011-02, *A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring* (ASU No. 2011-02). As a result of adopting the amendments in ASU No. 2011-02, the Company reassessed terms and conditions on restructured loans that had been completed in the past several months. In many instances, the Company was able to increase the interest rate on the loans and obtain additional collateral support for the borrowings, in exchange for extension of the loans terms. However, the new interest rate charged was considered to be at a below-market rate, which was determined to be a concession to its borrowers that were experiencing financial difficulties. Prior to their classification as troubled debt restructurings, these loans had been collectively evaluated for impairment consistent with the guidance in Subtopic 450-20. Upon identifying these receivables as troubled debt restructurings, the Company identified them as impaired under the guidance in Section 310-10-35. The amendments in ASU No. 2011-02 require prospective application of the impairment measurement guidance in Section 310-10-35 for those receivables newly identified as impaired. As a result of the adoption, the 2011 earnings have been negatively impacted by $3.4 million, representing the impairment valuation reserve at September 30, 2011 calculated under Section 310-10-35. Previous to the adoption of ASU No. 2011-02, a reserve was established on these loans under a general allowance methodology.

The following presents impaired loans that are troubled debt restructurings, with the recorded investment being both the pre-modification and post-modification balances, as well as the number of loans modified during the three and nine month periods, as of September 30, 2011 and December 31, 2010.

	Troubled Debt Restructurings At Period End		New Troubled Debt Restructurings Three Months Ended September 30,		New Troubled Debt Restructurings Nine Months Ended September 30,	
(Dollars in thousands)	**Number of Contracts**	**Recorded Investment**	**Number of Contracts**	**Recorded Investment**	**Number of Contracts**	**Recorded Investment**
September 30, 2011						
Accruing:						
Commercial real estate:						
Owner-occupied	1	$ 929	0	$ 0	1	$ 932
Non-owner occupied	3	2,271	1	749	3	2,276
Multi-family	1	894	0	0	1	894
Acquisition and development:						
1-4 family residential construction	1	129	0	0	1	133
Commercial and land development	4	3,830	0	0	4	3,831
Commercial and industrial	24	27,951	2	2,017	24	27,824
Residential mortgage:						
First lien	1	462	0	0	0	0
Home equity - term	1	709	0	0	0	0
	36	$ 37,175	3	$ 2,766	34	$ 35,890
Nonaccruing:						
Commercial and industrial	1	$ 550	1	$ 550	1	$ 550
December 31, 2010						
Accruing:						
Residential mortgage:						
First lien	1	$ 470				
Home equity - term	1	711				
	2	$ 1,181				

The loans presented above were considered troubled debt restructurings as the result of the Company agreeing to below market interest rates, allowing the loan to remain on interest only status, or for residential mortgage loans, a temporary reduction in interest rates for periods not exceeding 12 months in order to assist the borrowers to improve cash flows during such periods. No additional commitments have been made to borrowers whose loans are considered troubled debt restructurings. There were no modifications during the three and nine months ended September 30, 2010.

Management further monitors the performance and credit quality of the loan portfolio by analyzing the length of time a portfolio is past due, by aggregating loans based on its delinquencies. The following table presents the classes of loan portfolio summarized by aging categories of performing loans and nonaccrual loans as of September 30, 2011 and December 31, 2010:

		Days Past Due					
	Current	30-59	60-89	90+ (still accruing)	Total Past Due	Non-Accrual	Total Loans
September 30, 2011							
Commercial real estate:							

Owner-occupied	$ 187,462	$ 3,385	$ 247	$ 299	$ 3,931	$ 7,631	$ 199,024
Non-owner occupied	126,969	5,266	233	0	5,499	6,401	138,869
Multi-family	22,807	0	0	242	242	2,888	25,937
Acquisition and development:							
1-4 family residential construction	12,271	0	0	0	0	0	12,271
Commercial and land development	83,620	6,139	491	2,002	8,632	3,925	96,177
Commercial and industrial	269,100	1,157	757	320	2,234	8,951	280,285
Residential mortgage:							
First lien	103,261	1,023	649	81	1,753	850	105,864
Home equity - term	38,010	756	793	10	1,559	81	39,650
Home equity - Lines of credit	78,089	283	0	0	283	187	78,559
Installment and other loans	11,934	186	0	2	188	260	12,382
	$ 933,523	$ 18,195	$ 3,170	$ 2,956	$ 24,321	$ 31,174	$ 989,018

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	Days Past Due						
	Current	30-59	60-89	90+ (still accruing)	Total Past Due	Non-Accrual	Total Loans
December 31, 2010							
Commercial real estate:							
Owner-occupied	$ 169,030	$ 986	$ 832	$ 466	$ 2,284	$ 686	$ 172,000
Non-owner occupied	141,095	213	0	0	213	2,064	143,372
Multi-family	24,559	0	0	0	0	90	24,649
Acquisition and development:							
1-4 family residential construction	29,297	0	0	0	0	0	29,297
Commercial and land development	87,995	1	16	0	17	93	88,105
Commercial and industrial	252,144	287	466	420	1,174	10,625	263,943
Residential mortgage:							
First lien	116,182	1,359	535	1,095	2,989	279	119,450
Home equity - term	40,503	161	62	75	298	17	40,818
Home equity - Lines of credit	71,215	60	89	142	291	41	71,547
Installment and other loans	10,793	251	17	50	318	1	11,112
	$ 942,813	$ 3,318	$ 2,017	$ 2,248	$ 7,584	$ 13,896	$ 964,293

The Bank maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. It is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined methodology, which considers specific credit evaluations of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Section 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

For each loan class presented above, general allowances are provided for loans that are collectively evaluated for impairment, which are based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. As of December 31, 2010, the historical loss factor was based on average charge-offs for the last 8 quarters (e.g. January 1, 2009 December 31, 2010), whereas prior to December 31, 2010, the historical loss factor was based on an equally weighted rolling 12 quarters. Effective December 31, 2010, for loans rated special mention and substandard not deemed impaired, a weighted average rolling 8 quarters average charge-off percentage on the related graded loan type, with a two-third weight to the most recent four quarters, and a one-third weight for the furthest four quarters was utilized. For non-rated loans evaluated collectively for impairment, the charge-off factor for the last 8 quarters is factored into the reserve allocation. The refinement to the methodology was made as management determined that the most recent eight quarters, and in particular, the most recent four quarters for rated loans, is a better reflection of the losses inherent in the loan portfolio at December 31, 2010. Additional reserve allocations of approximately $730,000 resulted due to the change to the most recent 8 quarter history, which management believes is a better reflection of losses inherent in the portfolio based on recent loss history. In making this determination, management considered current economic and real estate conditions, trends in historical charge-off percentages at the Company as well as peers, and feedback from regulators.

In addition to the quantitative analysis, additional reserves are allocated on loans collectively evaluated for impairment based on additional qualitative factors. The qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which range from 0 10 basis point per factor, include:

National and local economic trends (five factors) Ratios and factors considered include trends in the consumer price index (CPI); unemployment rates; housing price index; housing starts compared to the prior year; and bankruptcy rates.

Credit quality trends (four factors) Ratios and factors considered include trends in delinquency ratios; 90 days plus and nonaccrual loans; average net loan losses to loans outstanding; and classified loans to total loans.

Underwriting policies (three factors) Factors considered including the number of exceptions to loan policy; supervisory loan to value exceptions; and the instances of repeat criticisms of ratings.

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Experience, ability and depth of lending and loan review staff (four factors) Factors considered include the years experience of the lending and loan review staff; turnover of the staff; instances of loan grade migration; and the penetration of loans reviewed.

Other (two factors) Other factors considered include concentrations of credit from loan type or shifts in industry or geographic region.

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

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Installment and Other	Unallocated	Total
Balance, beginning of period	$ 7,244	$ 5,026	$ 11,132	$ 2,150	$ 97	$ 1,563	$ 27,212
Provision for loan losses	5,466	3,084	(531)	(178)	38	21	7,900
Charge-offs	(4,179)	(2,707)	(2,466)	(64)	(23)	0	(9,439)
Recoveries	0	0	0	1	3	0	4
Balance, end of period	$ 8,531	$ 5,403	$ 8,135	$ 1,909	$ 115	$ 1,584	$ 25,677

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

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Installment and Other	Unallocated	Total
Balance, beginning of period	$ 5,324	$ 1,767	$ 6,795	$ 1,863	$ 106	$ 165	$ 16,020
Provision for loan losses	8,632	8,918	13,069	249	38	1,419	32,325
Charge-offs	(5,433)	(5,282)	(11,729)	(204)	(47)	0	(22,695)
Recoveries	8	0	0	1	18	0	27
Balance, end of period	$ 8,531	$ 5,403	$ 8,135	$ 1,909	$ 115	$ 1,584	$ 25,677

The roll forward of the allowance for loan losses for the three and nine months ended September 30, 2010 is as follows:

(Dollars in Thousands)	**Three Months Ended September 30, 2010**	**Nine Months Ended September 30, 2010**
Balance at beginning of period	$ 14,582	$ 11,067
Provision for loan losses	1,130	7,550
Recoveries	6	91
Loans charged-off	(332)	(3,322)
Balance at end of period	$ 15,386	$ 15,386

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The following summarizes the ending loan balance individually evaluated for impairment based upon loan segment, as well as the related allowance for loan loss allocation for each at September 30, 2011 and December 31, 2010:

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Installment and Other	Unallocated	Total
September 30, 2011							
Loans allocated by:							
Individually evaluated for impairment	$ 21,153	$ 7,884	$ 36,661	$ 1,174	$ 0	$ 0	$ 66,872
Collectively evaluated for impairment	342,677	100,564	243,624	222,899	12,382	0	922,146
	$ 363,830	$ 108,448	$ 280,285	$ 224,073	$ 12,382	$ 0	$ 989,018
Allowance for loan losses allocated by:							
Individually evaluated for impairment	$ 2,900	$ 1,174	$ 3,450				