UNITY BANCORP INC /NJ/
Form 10-Q
May 09, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2014

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.

(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 April 30, 2014 common stock, no par value: 7,605,093 shares outstanding

Table of Contents

PART ICONSOLIDATED FINANCIAL INFORMATION

ITEM 1Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

(In thousands)	March 31, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$ 30,025	$ 24,272
Federal funds sold and interest-bearing deposits	98,188	75,132
Cash and cash equivalents	128,213	99,404
Securities:		
Securities available for sale	86,154	81,133
Securities held to maturity (fair value of $22,736 and $25,549, respectively)	23,305	26,381
Total securities	109,459	107,514
Loans:		
SBA loans held for sale	6,517	6,673
SBA loans held for investment	47,737	48,918
SBA 504 loans	33,550	31,564
Commercial loans	368,909	363,340
Residential mortgage loans	180,129	182,067
Consumer loans	47,109	46,139
Total loans	683,951	678,701
Allowance for loan losses	(12,807)	(13,141)
Net loans	671,144	665,560
Premises and equipment, net	15,474	15,672
Bank owned life insurance ("BOLI")	12,845	12,749
Deferred tax assets	6,308	6,752
Federal Home Loan Bank stock	5,752	5,392
Accrued interest receivable	3,212	3,272
Other real estate owned ("OREO")	2,467	633
Goodwill and other intangibles	1,516	1,516
Other assets	4,778	2,654
Total assets	$ 961,168	$ 921,118
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Noninterest-bearing demand deposits	$ 172,010	$ 136,035
Interest-bearing demand deposits	134,321	130,806
Savings deposits	253,109	266,503
Time deposits, under $100,000	112,150	108,258

Time deposits, $100,000 and over	96,034	97,096
Total deposits	767,624	738,698
Borrowed funds	115,000	107,000
Subordinated debentures	15,465	15,465
Accrued interest payable	455	454
Accrued expenses and other liabilities	3,814	2,328
Total liabilities	902,358	863,945
Commitments and contingencies	-	-
Shareholders' equity:		
Common stock	52,237	52,051
Retained earnings	6,739	5,598
Accumulated other comprehensive income (loss)	(166)	(476)
Total shareholders' equity	58,810	57,173
Total liabilities and shareholders' equity	$ 961,168	$ 921,118
Issued and outstanding common shares	7,602	7,577

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

3

Unity Bancorp, Inc.

Consolidated Statements of Income

(Unaudited)

(In thousands, except per share amounts)	For the three months ended March 31, 2014	2013
INTEREST INCOME		
Federal funds sold and interest-bearing deposits	$ 9	$ 14
Federal Home Loan Bank stock	47	44
Securities:		
Taxable	726	647
Tax-exempt	105	120
Total securities	831	767
Loans:		
SBA loans	583	777
SBA 504 loans	399	651
Commercial loans	4,601	4,001
Residential mortgage loans	2,058	1,550
Consumer loans	495	509
Total loans	8,136	7,488
Total interest income	9,023	8,313
INTEREST EXPENSE		
Interest-bearing demand deposits	111	101
Savings deposits	182	177
Time deposits	644	546
Borrowed funds and subordinated debentures	799	800
Total interest expense	1,736	1,624
Net interest income	7,287	6,689
Provision for loan losses	600	650
Net interest income after provision for loan losses	6,687	6,039
NONINTEREST INCOME		
Branch fee income	377	347
Service and loan fee income	295	304
Gain on sale of SBA loans held for sale, net	83	241
Gain on sale of mortgage loans, net	365	477
BOLI income	96	70
Net security gains	110	226
Other income	200	160
Total noninterest income	1,526	1,825
NONINTEREST EXPENSE		
Compensation and benefits	3,217	3,176
Occupancy	659	694
Processing and communications	582	561
Furniture and equipment	357	365

Professional services	211	190
Loan costs	170	177
OREO expenses	247	127
Deposit insurance	178	149
Advertising	151	120
Other expenses	486	567
Total noninterest expense	6,258	6,126
Income before provision for income taxes	1,955	1,738
Provision for income taxes	662	538
Net income	1,293	1,200
Preferred stock dividends and discount accretion	-	404
Income available to common shareholders	$ 1,293	$ 796
Net income per common share - Basic	$ 0.17	$ 0.11
Net income per common share - Diluted	$ 0.17	$ 0.10
Weighted average common shares outstanding - Basic	7,586	7,538
Weighted average common shares outstanding - Diluted	7,654	7,845

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

4

Unity Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

	For the three months ended March 31,	
(In thousands)	2014	2013
Net income	$ 1,293	$ 1,200
Other comprehensive income (loss), net of tax:		
Unrealized holding gains (losses) on securities arising during period	383	(230)
Less: Reclassification adjustment for gains on securities included in net income	73	150
Total other comprehensive income (loss)	310	(380)
Total comprehensive income	$ 1,603	$ 820

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 three months ended March 31, 2014 and 2013

(Unaudited)

(In thousands)	Preferred stock	Common stock Shares	Common stock Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
Balance, December 31, 2013	$ -	7,577	$ 52,051	$ 5,598	$ (476)	$ 57,173
Net income				1,293		1,293
Other comprehensive income, net of tax					310	310
Dividends on common stock ($0.02 per share)			12	(152)		(140)
Common stock issued and related tax effects (1)		25	174			174
Balance, March 31, 2014	$ -	7,602	$ 52,237	$ 6,739	$ (166)	$ 58,810

(In thousands)	Preferred stock	Common stock Shares	Common stock Amount	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance, December 31, 2012	$ 20,115	7,534	$ 54,274	$ 1,788	$ 1,333	$ 77,510
Net income				1,200		1,200
Other comprehensive loss, net of tax					(380)	(380)
Accretion of discount on preferred stock	148			(148)		-
Dividends on preferred stock (5% annually)				(256)		(256)
Common stock issued and related tax effects (1)		14	83			83
Balance, March 31, 2013	$ 20,263	7,548	$ 54,357	$ 2,584	$ 953	$ 78,157

(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.

6

Unity Bancorp, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	For the three months ended March 31, 2014		2013	
OPERATING ACTIVITIES:				
Net income	$	1,293	$	1,200
Adjustments to reconcile net income to net cash provided by operating activities:				
Provision for loan losses		600		650
Net amortization of purchase premiums and discounts on securities		130		208
Depreciation and amortization		397		365
Deferred income tax expense (benefit)		244		(32)
Net security gains		(110)		(226)
Stock compensation expense		100		83
Loss on sale of OREO		99		-
Valuation writedowns on OREO		-		70
Gain on sale of mortgage loans held for sale, net		(220)		(477)
Gain on sale of SBA loans held for sale, net		(83)		(241)
Origination of mortgage loans held for sale		(17,448)		(22,599)
Origination of SBA loans held for sale		(890)		(1,911)
Proceeds from sale of mortgage loans held for sale, net		17,668		23,076
Proceeds from sale of SBA loans held for sale, net		1,011		2,533
Net change in other assets and liabilities		(661)		(674)
Net cash provided by operating activities		2,130		2,025
INVESTING ACTIVITIES				
Purchases of securities held to maturity		-		(8,252)
Purchases of securities available for sale		(9,947)		(13,086)

Purchases of Federal Home Loan Bank stock, at cost		(1,800)		-
Maturities and principal payments on securities held to maturity		3,060		1,446
Maturities and principal payments on securities available for sale		2,536		5,692
Proceeds from sales of securities available for sale		2,895		5,303
Proceeds from redemption of Federal Home Loan Bank stock		1,440		-
Proceeds from sale of OREO		487		704
Net increase in loans		(8,779)		(11,051)
Purchases of premises and equipment		(61)		(96)
Net cash used in investing activities		(10,169)		(19,340)
FINANCING ACTIVITIES				
Net increase in deposits		28,926		3,357
Proceeds from new borrowings		40,000		-
Repayments of borrowings		(32,000)		-
Proceeds from exercise of stock options		62		-
Dividends on preferred stock		-		(258)
Dividends on common stock		(140)		-
Net cash provided by financing activities		36,848		3,099
Increase (decrease) in cash and cash equivalents		28,809		(14,216)
Cash and cash equivalents, beginning of period		99,404		94,192
Cash and cash equivalents, end of period	$	128,213	$	79,976
SUPPLEMENTAL DISCLOSURES				
Cash:				
Interest paid	$	1,735	$	1,620
Income taxes paid		459		481
Noncash investing activities:				
Transfer of SBA loans held for sale to held to maturity		111		-
Transfer of loans to OREO		2,420		-
Purchase of leased branch locations		-		3,893

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

Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

March 31, 2014

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 three months ended March 31, 2014 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, 2013.

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 three months ended March 31, 2014 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, 2013	448,975	$ 6.70	5.6	$ 739,951
Options granted	40,000	7.90		
Options exercised	(19,950)	4.62		
Options expired	(7,619)	10.84		
Outstanding at March 31, 2014	461,406	$ 6.83	5.8	$ 781,620
Exercisable at March 31, 2014	344,908	$ 6.78	4.8	$ 668,639

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 March 31, 2014, 1,720,529 shares have been reserved for issuance upon the exercise of options, 461,406 option grants are outstanding, and 1,205,431 option grants have been exercised, forfeited or expired, leaving 53,692 shares available for grant.

The fair values of the options granted during the three months ended March 31, 2014 and 2013 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 March 31, 2014	2013
Number of options granted	40,000	25,000
Weighted average exercise price	$ 7.90	$ 6.02
Weighted average fair value of options	$ 3.03	$ 2.91
Expected life in years (1)	5.40	5.11
Expected volatility (2)	45.21 %	52.81 %
Risk-free interest rate (3)	1.52 %	0.77 %
Dividend yield (4)	1.02 %	- %

(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 months ended March 31, 2014 and 2013:

	For the three months ended March 31, 2014	2013
Number of options exercised	19,950	N/A
Total intrinsic value of options exercised	$ 67,417	$ N/A
Cash received from options exercised	62,445	N/A
Tax deduction realized from options exercised	26,926	N/A

The following table summarizes information about stock options outstanding and exercisable at March 31, 2014:

Options outstanding	Options exercisable

Range of exercise prices	Options outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$ 0.00 - 4.00	107,000	5.1	$ 3.87	107,000	$ 3.87
4.01 - 7.00	167,000	7.4	6.14	103,002	6.06
7.01 - 10.00	138,882	5.6	7.96	86,382	8.03
10.01 - 13.00	48,524	2.5	12.46	48,524	12.46
Total	461,406	5.8	$ 6.83	344,908	$ 6.78

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 months ended March 31, 2014 and 2013 are detailed in the following table:

	For the three months ended March 31,	
	2014	2013
Compensation expense	$ 40,563	$ 35,020
Income tax benefit	16,201	13,987

As of March 31, 2014, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company’s stock option plans totaled approximately $274 thousand. That cost is expected to be recognized over a weighted average period of 2.3 years.

9

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 three months ended March 31, 2014:

	Shares	Average grant date fair value
Nonvested restricted stock at December 31, 2013	95,625	$ 6.67
Granted	10,000	7.84
Vested	(3,500)	6.21
Nonvested restricted stock at March 31, 2014	102,125	$ 6.80

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 March 31, 2014, 471,551 shares of restricted stock were reserved for issuance, of which 222,838 shares are available for grant.

Restricted stock awards granted during the three months ended March 31, 2014 and 2013 were as follows:

	For the three months ended March 31,	
	2014	2013
Number of shares granted	10,000	14,000
Average grant date fair value	$ 7.84	$ 6.02

Compensation expense related to restricted stock for the three months ended March 31, 2014 and 2013 is detailed in the following table:

	For the three months ended March 31,	
	2014	2013
Compensation expense	$ 59,270	$ 47,935
Income tax benefit	23,672	19,145

As of March 31, 2014, there was approximately $600 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 2.9 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.

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 individually evaluated for impairment. 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.

12

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.

	For the three months ended March 31,	
(In thousands, except per share amounts)	2014	2013
Net income	$ 1,293	$ 1,200
Less: Preferred stock dividends and discount accretion	-	404
Income available to common shareholders	$ 1,293	$ 796
Weighted average common shares outstanding - Basic	7,586	7,538
Plus: Potential dilutive common stock equivalents	68	307
Weighted average common shares outstanding - Diluted	7,654	7,845
Net income per common share - Basic	$ 0.17	$ 0.11
Net income per common share - Diluted	0.17	0.10
Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive	126	379

The "potential dilutive common stock equivalents" shown in the table above for March 31, 2013 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 March 31, 2014, the Company reported income tax expense of $662 thousand for an effective tax rate of 33.9 percent, compared to an income tax expense of $538 thousand and effective tax rate of 31.0 percent for the prior year’s quarter. The Company did not recognize or accrue any interest or penalties related to income taxes during the three months ended March 31, 2014 or 2013. The Company did not have an accrual for uncertain tax positions as of March 31, 2014 or December 31, 2013, 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 March 31, 2014 and 2013:

	For the three months ended March 31,					
	2014			2013		
(In thousands)	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Balance, beginning of period			$ (476)			$ 1,333
Unrealized holding gains (losses) on securities arising during the period	$ 618	$ 235	383	$ (409)	$ (179)	(230)
Less: Reclassification adjustment for gains included in net income	110	37	73	226	76	150
Net unrealized gains (losses) on securities arising during the period	$ 508	$ 198	$ 310	$ (635)	$ (255)	$ (380)
Balance, end of period			$ (166)			$ 953

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 March 31, 2014, the fair value of the Company's AFS securities portfolio was $86.2 million. Approximately 55 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $47.4 million at March 31, 2014. Approximately $46.1 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 March 31, 2014. 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 March 31, 2014:

March 31, 2014					
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.

There were no changes in the inputs or methodologies used to determine fair value during the period ended March 31, 2014, as compared to the periods ended December 31, 2013 and March 31, 2013.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of March 31, 2014 and December 31, 2013:

	March 31, 2014			
(In thousands)	Level 1	Level 2	Level 3	Total
Securities available for sale:				
U.S. Government sponsored entities	$ -	$ 8,251	$ -	$ 8,251
State and political subdivisions	-	16,125	-	16,125
Residential mortgage-backed securities	-	47,360	-	47,360
Commercial mortgage-backed securities	-	-	499	499
Corporate and other securities	-	13,919	-	13,919
Total securities available for sale	$ -	$ 85,655	$ 499	$ 86,154

	December 31, 2013			
(In thousands)	Level 1	Level 2	Level 3	Total
Securities available for sale:				
U.S. Government sponsored entities	$ -	$ 6,418	$ -	$ 6,418
State and political subdivisions	-	16,598	-	16,598
Residential mortgage-backed securities	-	44,389	-	44,389
Commercial mortgage-backed securities	-	-	888	888
Corporate and other securities	-	12,840	-	12,840
Total securities available for sale	$ -	$ 80,245	$ 888	$ 81,133

The following table summarizes changes in Level 3 assets during the three months ended March 31, 2014 and 2013, consisting of commercial mortgage-backed available for sale securities, measured at fair value on a recurring basis:

	For the three ended March 31,	
(In thousands)	2014	2013
Commercial mortgage-backed securities:		
Balance, beginning of period	$ 888	$ 4,463
Payoffs	(291)	(505)
Principal paydowns	(96)	(244)
Total net losses included in:		

Other comprehensive income	(2)	(33)
Balance, end of period	$ 499	$ 3,681

There were no gains or losses (realized or unrealized) on Level 3 securities included in earnings for assets and liabilities held at March 31, 2014 or 2013.

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 generally when the borrower makes six 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 March 31, 2014 and December 31, 2013, the valuation allowance for impaired loans was $1.1 million.

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 March 31, 2014 and the fair value gains (losses) recognized during the three ended March 31, 2014 and 2013:

(In thousands)	Fair value at March 31, 2014 Level 1	Level 2	Level 3	Total	Gains (losses) from fair value changes for the three months ended March 31, 2014
Financial assets:					
OREO	$ -	$ -	$ 2,467	$ 2,467	$ (400)
Impaired collateral-dependent loans	-	-	2,363	2,363	(1)

(In thousands)	Fair value at March 31, 2013 Level 1	Level 2	Level 3	Total	Gains (losses) from fair value changes for the three months ended March 31, 2013
Financial assets:					
OREO	$ -	$ -	$ 300	$ 300	$ (70)
Impaired collateral-dependent loans	-	-	9,290	9,290	