

ORRSTOWN FINANCIAL SERVICES INC

Form 10-Q

May 08, 2015

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10 – Q

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

For the quarterly period ended March 31, 2015

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)

Pennsylvania 23-2530374  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)  
77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania 17257  
(Address of Principal Executive Offices) (Zip Code)  
Registrant’s Telephone Number, Including Area Code: (717) 532-6114

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Number of shares outstanding of the registrant’s Common Stock as of May 4, 2015: 8,295,111.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

## Consolidated Balance Sheets (Unaudited)

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

(Dollars in thousands, except per share data)	March 31, 2015	December 31, 2014
Assets		
Cash and due from banks	\$21,182	\$18,174
Interest bearing deposits with banks	11,856	13,235
Cash and cash equivalents	33,038	31,409
Restricted investments in bank stock	7,678	8,350
Securities available for sale	349,827	376,199
Loans held for sale	5,177	3,159
Loans	727,753	704,946
Less: Allowance for loan losses	(14,461	) (14,747
Net loans	713,292	690,199
Premises and equipment, net	24,325	24,800
Cash surrender value of life insurance	26,829	26,645
Intangible assets	363	414
Accrued interest receivable	3,049	3,097
Other assets	25,842	26,171
Total assets	\$1,189,420	\$1,190,443
Liabilities		
Deposits:		
Non-interest bearing	\$129,593	\$116,302
Interest bearing	816,163	833,402
Total deposits	945,756	949,704
Short-term borrowings	75,272	86,742
Long-term debt	24,734	14,812
Accrued interest and other liabilities	11,804	11,920
Total liabilities	1,057,566	1,063,178
Shareholders' 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; 8,295,922 and 8,264,554 shares issued; 8,295,111 and 8,263,743 shares outstanding	430	430
Additional paid - in capital	123,573	123,392
Retained earnings	4,349	1,887
Accumulated other comprehensive income	3,522	1,576
Treasury stock—common, 811 shares, at cost	(20	) (20
Total shareholders' equity	131,854	127,265
Total liabilities and shareholders' equity	\$1,189,420	\$1,190,443

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



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## Consolidated Statements of Income (Unaudited)

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

(Dollars in thousands, except per share data)	Three Months Ended	
	March 31, 2015	March 31, 2014
Interest and dividend income		
Interest and fees on loans	\$7,327	\$7,441
Interest and dividends on investment securities		
Taxable	1,820	1,918
Tax-exempt	55	234
Short-term investments	26	8
Total interest and dividend income	9,228	9,601
Interest expense		
Interest on deposits	777	956
Interest on short-term borrowings	60	33
Interest on long-term debt	76	96
Total interest expense	913	1,085
Net interest income	8,315	8,516
Provision for loan losses	0	0
Net interest income after provision for loan losses	8,315	8,516
Noninterest income		
Service charges on deposit accounts	1,193	1,269
Other service charges, commissions and fees	173	188
Trust department income	1,247	1,208
Brokerage income	437	448
Mortgage banking activities	520	459
Earnings on life insurance	229	234
Other income	40	35
Investment securities gains	1,529	597
Total noninterest income	5,368	4,438
Noninterest expenses		
Salaries and employee benefits	5,900	5,812
Occupancy expense	624	635
Furniture and equipment	743	836
Data processing	467	381
Automated teller and interchange fees	206	180
Advertising and bank promotions	245	425
FDIC insurance	246	464
Professional services	512	628
Collection and problem loan	96	159
Real estate owned expenses	25	27
Taxes other than income	226	158
Intangible asset amortization	51	52
Other operating expenses	1,165	1,219
Total noninterest expenses	10,506	10,976
Income before income taxes	3,177	1,978
Income tax expense	715	0
Net income	\$2,462	\$1,978
Per share information:		

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Basic earnings per share	\$0.30	\$0.24
Diluted earnings per share	0.30	0.24
Dividends per share	0.00	0.00

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

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## Consolidated Statements of Comprehensive Income (Unaudited)

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

(Dollars in thousands)	Three Months Ended	
	March 31, 2015	March 31, 2014
Net income	\$2,462	\$1,978
Other comprehensive income, net of tax:		
Unrealized gains on securities available for sale arising during the period	4,523	4,868
Reclassification adjustment for gains realized in net income	(1,529	) (597
Net unrealized gains	2,994	4,271
Tax effect	(1,048	) (1,495
Total other comprehensive income, net of tax and reclassification adjustments	1,946	2,776
Total comprehensive income	\$4,408	\$4,754

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



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## Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

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

(Dollars in thousands, except per share data)	Three Months Ended March 31, 2015 and 2014					
	Common Stock	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance, January 1, 2014	\$422	\$123,105	\$(27,255)	\$ (4,813)	\$(20)	\$91,439
Net income	0	0	1,978	0	0	1,978
Total other comprehensive income, net of taxes	0	0	0	2,776	0	2,776
Stock-based compensation plans:						
Issuance of stock (3,348 shares), including compensation expense of \$12	0	59	0	0	0	59
Issuance of stock through dividend reinvestment plan (7 shares)	0	0	0	0	0	0
Balance, March 31, 2014	\$422	\$123,164	\$(25,277)	\$ (2,037)	\$(20)	\$96,252
Balance, January 1, 2015	\$430	\$123,392	\$1,887	\$ 1,576	\$(20)	\$127,265
Net income	0	0	2,462	0	0	2,462
Total other comprehensive income, net of taxes	0	0	0	1,946	0	1,946
Stock-based compensation plans:						
Issuance of stock (31,358 shares), including compensation expense of \$134	0	181	0	0	0	181
Issuance of stock through dividend reinvestment plan (10 shares)	0	0	0	0	0	0
Balance, March 31, 2015	\$430	\$123,573	\$4,349	\$ 3,522	\$(20)	\$131,854

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

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## Consolidated Statements of Cash Flows (Unaudited)

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

(Dollars in thousands)	Three Months Ended	
	March 31, 2015	March 31, 2014
Cash flows from operating activities		
Net income	\$2,462	\$1,978
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	1,534	1,358
Depreciation and amortization	741	765
Stock based compensation	134	12
Net change in loans held for sale	(2,018	) (716
Net gain on disposal of other real estate owned	(7	) 0
Net loss on disposal of premises and equipment	0	46
Deferred income taxes, including valuation allowance	726	0
Investment securities gains	(1,529	) (597
Earnings on cash surrender value of life insurance	(229	) (234
Decrease in accrued interest receivable	48	116
Increase (decrease) in accrued interest payable and other liabilities	(116	) 1,196
Other, net	(986	) 80
Net cash provided by operating activities	760	4,004
Cash flows from investing activities		
Proceeds from sales of available for sale securities	41,382	67,567
Maturities, repayments and calls of available for sale securities	7,838	11,205
Purchases of available for sale securities	(19,859	) (87,383
Net redemptions of restricted investments in bank stocks	672	907
Net increase in loans	(23,842	) (4,346
Purchases of bank premises and equipment	(126	) (649
Proceeds from disposal of other real estate owned	253	0
Net cash provided by (used in) investing activities	6,318	(12,699
Cash flows from financing activities		
Net increase (decrease) in deposits	(3,948	) 2,015
Net decrease in short term purchased funds	(11,470	) (10,211
Proceeds from long-term debt	20,000	10,000
Payments on long-term debt	(10,078	) (359
Dividends paid	0	0
Net proceeds from issuance of common stock	47	47
Net cash provided by (used in) financing activities	(5,449	) 1,492
Net increase (decrease) in cash and cash equivalents	1,629	(7,203
Cash and cash equivalents at beginning of period	31,409	37,560
Cash and cash equivalents at end of period	\$33,038	\$30,357
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$923	\$1,079
Income taxes	0	0
Supplemental schedule of noncash investing activities:		
Other real estate acquired in settlement of loans	\$745	\$1,625
Security purchases not yet settled	0	12,751

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



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Notes to Consolidated Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations – Orrstown Financial Services, Inc. (the “Company”) is a bank holding company (that has elected status as a financial holding company with the Board of Governors of the Federal Reserve System (the “FRB”)) whose primary activity consists of supervising its wholly-owned subsidiary, Orrstown Bank (the “Bank”). The Company operates through its office in Shippensburg, Pennsylvania. The Bank provides services through its network of 22 offices in Cumberland, Franklin, Lancaster, 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 Company and the Bank are subject to the regulation of certain federal and state agencies and undergo periodic examinations by such regulatory authorities.

Basis of Presentation – The unaudited consolidated financial statements of the Company and its subsidiary are presented for the three months ended March 31, 2015 and 2014 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 GAAP for complete financial statements. However, 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, 2014 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, 2014. The consolidated financial statements include the accounts of the Company and the Bank. Operating results for the three months ended March 31, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. All significant intercompany transactions and accounts have been eliminated.

Use of Estimates – The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ.

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 specifies the disclosures that should be made about events or transactions that occur after the balance sheet date.

Concentration of Credit Risk – The Company grants commercial, residential, construction, municipal, and various forms of 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 commercial real estate, including office space, retail strip centers, multi-family and hospitality, 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 due on demand, all of which have original maturities of 90 days or less. Net cash flows are reported for customer loan and deposit transactions, loans held for sale and redemption (purchases) of restricted investments in bank stocks.

Restricted Investments in Bank Stocks – Restricted investments in bank stocks, which represents required investments in the common stock of correspondent banks, is carried at cost as of March 31, 2015 and December 31, 2014, and consists of common stock of the Federal Reserve Bank of Philadelphia (“Federal Reserve Bank”), Atlantic Community Bankers Bank and the Federal Home Loan Bank of Pittsburgh (“FHLB”) stocks.

Management evaluates the restricted investment in bank stocks for impairment in accordance with Accounting Standard Codification (ASC) Topic 942, Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or

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Finance the Activities of Others. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the correspondent bank as compared to the capital stock amount for the correspondent bank and the length of time this situation has persisted, (2) commitments by the correspondent bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of the correspondent bank, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the correspondent bank.

Management believes no impairment charge is necessary related to the restricted investments in bank stocks as of March 31, 2015. However, security impairment analysis is completed quarterly and the determination that no impairment had occurred as of March 31, 2015 is no assurance that impairment may not occur in the future.

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 March 31, 2015 and December 31, 2014, the Company had 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 and approximate the level yield method. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

The Company had no debt securities it deemed to be other than temporarily impaired at March 31, 2015 and December 31, 2014.

The Company's securities are exposed to various risks, such as interest rate risk, market risk, 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.

Loans Held for Sale – Loans originated and intended for sale in the secondary market are carried at the 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.

Loans – The Company grants commercial, residential, commercial mortgage, construction, mortgage and various forms of 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 largely 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

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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, the loan has performed in accordance with the contractual terms of the note for a reasonable period of time, generally six 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.

Loans, the terms of which are modified, are classified as troubled debt restructurings ("TDRs") if a concession was granted, for legal or economic reasons, related to a debtor's financial difficulties. Concessions granted under a TDR typically involve a temporary deferral of scheduled loan payments, an extension of a loan's stated maturity date, temporary reduction in interest rates, or granting of an interest rate below market rates given the risk of the transaction. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual TDRs may be restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. TDRs 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 a valuation allowance for probable incurred credit losses. 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.

Loans Serviced – The Bank administers secondary market mortgage programs available through the FHLB and the Federal National Mortgage Association and offers residential mortgage products and services to customers. The Bank originates single-family residential mortgage loans for immediate sale in the secondary market, and retains the servicing of those loans. At March 31, 2015 and December 31, 2014, the balance of loans serviced for others was \$311,920,000 and \$315,239,000.

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.

Premises and Equipment – Buildings, improvements, equipment, furniture and fixtures are carried at cost less accumulated depreciation and amortization. Land is carried at cost. Depreciation and amortization has been provided generally on the straight-line method and is computed over the estimated useful lives of the various assets as follows: buildings and improvements, including leasehold improvements – 10 to 40 years; and furniture and equipment – 3 to 15 years. Repairs and maintenance are charged to operations as incurred, while major additions and improvements are capitalized. Gain or loss on retirement or disposal of individual assets is recorded as income or expense in the period of retirement or disposal.

Mortgage Servicing Rights – The estimated fair value of mortgage servicing rights (MSRs) related to loans sold and serviced by the Company is recorded as an asset upon the sale of such loans. MSRs are amortized as a reduction to servicing income over the estimated lives of the underlying loans. MSRs are evaluated periodically for impairment, by comparing the carrying amount to estimated fair value. Fair value is determined periodically through a discounted cash flows valuation performed by a third party. Significant inputs to the valuation include expected servicing income, net of expense, the discount rate and the expected life of the underlying loans. To the extent the amortized cost of the MSRs exceeds their estimated fair values, a valuation allowance is established for such impairment through a charge against servicing income on the consolidated statement of income. If the Company determines, based on subsequent valuations, that impairment no longer exists or is reduced, the valuation allowance is reduced through a credit to



earnings.

Foreclosed Real Estate – Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less estimated costs to sell the underlying collateral. Capitalized costs include any costs that significantly improve the value of the properties. After foreclosure, valuations are periodically performed by management and

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the real estate is carried at the lower of carrying amount or fair value less estimated costs to sell. Foreclosed real estate totaled \$1,431,000 and \$932,000 as of March 31, 2015 and December 31, 2014 and is included in other assets.

Securities Sold Under Agreements to Repurchase (“Repurchase Agreements”) – The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities which are included in short-term borrowings. Under these agreements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these Repurchase Agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Company’s consolidated balance sheet, while the securities underlying the Repurchase Agreements remain in the respective investment securities asset accounts. In other words, there is no offsetting or netting of the investment securities assets with the Repurchase Agreement liabilities. In addition, as the Company does not enter into reverse Repurchase Agreements, there is no such offsetting to be done with the Repurchase Agreements.

The right of setoff for a Repurchase Agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the Repurchase Agreement should the Company be in default (e.g., fails to make an interest payment to the counterparty). For the Repurchase Agreements, the collateral is held by the Company in a segregated custodial account under a third party agreement.

Advertising – The Company follows the policy of charging costs of advertising to expense as incurred. Advertising expense was \$112,000 and \$233,000 for the three months ended March 31, 2015 and 2014.

Stock Compensation Plans – The Company has stock compensation plans that cover 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 award, including a Black-Scholes model for stock options. Compensation cost for all stock awards is 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.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management’s judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized. The Company recognizes interest and penalties, if any, on income taxes as a component of income tax expense.

Treasury Stock – Common stock shares repurchased are recorded as treasury stock at cost.

Earnings Per Share – Basic earnings per share represent net income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Restricted stock awards are included in weighted average common shares outstanding as they are earned. Diluted earnings 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 related solely to outstanding stock options and restricted stock awards.

Treasury shares are not deemed outstanding for earnings per share calculations.

Comprehensive Income – Comprehensive income consists of net income and other comprehensive income. Other comprehensive income is limited to unrealized gains on securities available for sale for all years presented.

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The component of accumulated other comprehensive income, net of taxes, at March 31, 2015 and December 31, 2014 consisted of unrealized gains on securities available for sale and totaled \$3,522,000 and \$1,576,000.

Fair Value of Financial Instruments – Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 9. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

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.

Reclassification – Certain amounts in the 2014 consolidated financial statements have been reclassified to conform to the 2015 presentation.

Recent Accounting Pronouncements – In January 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-1, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. ASU 2014-1 permits reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in ASU 2014-1 should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those pre-existing investments. ASU 2014-1 is effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. The Company anticipates it will use the proportional amortization in future projects it enters into. However the existing projects did not qualify for this approach, and as such, the adoption of this ASU did not have a significant impact on the Company's financial statements.

In January 2014, the FASB issued ASU 2014-4, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. ASU 2014-4 clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU 2014-4 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in ASU 2014-4 using either a modified retrospective transition method or a prospective transition method. The adoption of ASU 2014-4 did not have a significant impact on the Company's operating results or financial condition.

In May 2014, the FASB issued ASU 2014-9, Revenue from Contracts with Customers (Topic 606). ASU 2014-9, creates a new topic, Topic 606, to provide guidance on revenue recognition for entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional disclosures are required to provide quantitative and qualitative information regarding the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. ASU 2014-9 is effective for annual reporting periods, and interim reporting periods within those annual periods, beginning after December 15, 2016. Early adoption is not permitted. Management is currently evaluating the impact of the adoption of this guidance on the Company's financial statements.

In June 2014, the FASB issued ASU 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. ASU 2014-11 changes the accounting for repurchase-to-maturity transactions and linked repurchase financings to secured borrowing accounting, which is consistent with the accounting for other repurchase agreements. The pronouncement also requires two new disclosures. The first disclosure requires an entity to disclose information on transfers accounted for as sales in transactions that are economically similar to repurchase agreements. The second disclosure provides increased transparency about the types of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. ASU 2014-11 is effective for public business entities for annual periods, and

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interim periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU did not have a significant impact on the Company's operating results or financial condition.

In August 2014, FASB issued ASU 2014-14, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure. ASU 2014-14 amends existing guidance related to the classification of certain government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA, upon foreclosure. It requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if the following conditions are met: 1) The loan has a government guarantee that is not separable from the loan before the foreclosure; 2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and 3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance, including principal and interest, expected to be recovered from the guarantor. These amendments are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted if the amendments under ASU 2014-04, have been adopted. The amendments may be applied using a prospective transition method in which a reporting entity applies the guidance to foreclosures that occur after the date of adoption, or a modified retrospective transition using a cumulative-effect adjustment (through a reclassification to separate other receivable) as of the beginning of the annual period of adoption. Prior periods should not be adjusted. A reporting entity must apply the same method of transition as elected under ASU 2014-04. The Company's adoption of this standard on January 1, 2015 did not have a significant impact on the Company's operating results or financial condition.

**NOTE 2. SECURITIES AVAILABLE FOR SALE**

At March 31, 2015 and December 31, 2014, 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 March 31, 2015 and December 31, 2014 were:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2015				
U.S. Government Agencies	\$ 28,282	\$ 97	\$ 29	\$28,350
States and political subdivisions	57,826	1,046	393	58,479
U.S. Government Sponsored Enterprises (GSE) residential mortgage-backed securities	158,610	2,599	0	161,209
GSE residential collateralized mortgage obligations (CMOs)	30,071	492	85	30,478
GSE commercial CMOs	69,570	1,742	69	71,243
Total debt securities	344,359	5,976	576	349,759
Equity securities	50	18	0	68
Totals	\$ 344,409	\$ 5,994	\$ 576	\$349,827
December 31, 2014				
U.S. Government Agencies	\$ 23,910	\$ 71	\$ 23	\$23,958
States and political subdivisions	52,578	819	996	52,401
GSE residential mortgage-backed securities	174,220	1,573	197	175,596
GSE residential CMOs	57,976	857	128	58,705
GSE commercial CMOs	65,041	1,017	586	65,472
Total debt securities	373,725	4,337	1,930	376,132
Equity securities	50	17	0	67
Totals	\$ 373,775	\$ 4,354	\$ 1,930	\$376,199



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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 the individual securities have been in a continuous unrealized loss position at March 31, 2015 and December 31, 2014:

(Dollars in thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2015						
U.S. Government Agencies	\$10,726	\$26	\$3,546	\$3	\$14,272	\$29
States and political subdivisions	8,834	22	14,426	371	23,260	393
GSE residential collateralized mortgage obligations (CMOs)	3,321	29	5,449	56	8,770	85
GSE commercial CMOs	24,638	69	0	0	24,638	69
Total temporarily impaired securities	\$47,519	\$146	\$23,421	\$430	\$70,940	\$576
December 31, 2014						
U.S. Government Agencies	\$0	\$0	\$9,012	\$23	\$9,012	\$23
States and political subdivisions	0	0	35,833	996	35,833	996
GSE residential mortgage-backed securities	65,474	197	0	0	65,474	197
GSE residential CMOs	11,930	128	0	0	11,930	128
GSE commercial CMOs	0	0	29,969	586	29,969	586
Total temporarily impaired securities	\$77,404	\$325	\$74,814	\$1,605	\$152,218	\$1,930

The Company had 23 securities and 37 securities at March 31, 2015 and December 31, 2014 in which the amortized cost exceed their values, as discussed below.

U.S. Agencies and Government Sponsored Enterprises (GSE). Thirteen U.S. Agencies and GSE securities, including mortgage-backed securities and collateralized mortgage obligations, have amortized costs which exceed their fair values, 8 of which are in the less than 12 months category at March 31, 2015. At December 31, 2014, the Company had 21 U.S. Government Agencies and GSE securities, including mortgage-backed and collateralized mortgage obligations with unrealized losses, 13 GSE securities have amortized costs which exceed their fair values for less than 12 months, and eight have amortized costs which exceed their fair values for more than 12 months. These unrealized losses have been caused by a rise in interest rates or widening of spreads 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 par value basis of the investments. Because the Company did 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 basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2015 or at December 31, 2014.

State and Political Subdivisions. Ten state and political subdivision securities have amortized costs which exceeded their fair values, 5 of which are in the less than 12 months category at March 31, 2015. At December 31, 2014, 16 state and political subdivision securities have an amortized cost which exceeds their fair value for more than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. Management considers the investment rating, the state of the issuer of the security and other credit support in determining whether the security is other-than-temporarily impaired. Because the Company did 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 basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2015 or at December 31, 2014.



The amortized cost and fair values of securities available for sale at March 31, 2015 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.

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(Dollars in thousands)	Available for Sale	
	Amortized Cost	Fair Value
Due in one year or less	\$0	\$0
Due after one year through five years	875	918
Due after five years through ten years	37,787	38,272
Due after ten years	47,446	47,639
Mortgage-backed securities and collateralized mortgage obligations	258,251	262,930
Total debt securities	344,359	349,759
Equity securities	50	68
	\$344,409	\$349,827

Gross gains on the sales of securities were \$1,553,000 and \$646,000 for the three months ended March 31, 2015 and 2014. Gross losses on securities available for sale were \$24,000 and \$49,000 for the three months ended March 31, 2015 and 2014.

Securities with a fair value of \$244,614,000 and \$261,034,000 at March 31, 2015 and December 31, 2014 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 Company'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. Consistent with ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses, 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 has 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 borrower's 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.

Non-owner occupied and multi-family commercial real estate loans and non-owner occupied residential loans present a different credit risk to the Company than owner-occupied commercial real estate loans, 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 requirements and operating expenses. Lower occupancy or lease rates may result in a reduction in cash flows, which hinders the ability of the borrower to meet debt service requirements, and may result in lower collateral values. The Company generally recognizes that greater risk is inherent in these credit relationships as compared to owner occupied loans mentioned above in its loan pricing.

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.

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 significant number 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

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the value of the collateral may decline. The Company attempts to mitigate this risk through its 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 typical. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

Municipal loans consist of extensions of credit to municipalities and school districts within the Company's market area. These loans generally present a lower risk than commercial and industrial loans, as they are generally secured by the municipality's full taxing authority, by revenue obligations, or by its ability to raise assessments on its customers for a specific utility.

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 loan. 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 limit the loan-to-value ratio to generally no more than 80% upon loan origination, 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 43%.

Installment and other loans' credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower through 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 typically 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 March 31, 2015 and December 31, 2014 was as follows:

(Dollars in thousands)	March 31, 2015	December 31, 2014
Commercial real estate:		
Owner-occupied	\$ 111,399	\$ 100,859
Non-owner occupied	150,921	144,301
Multi-family	28,943	27,531
Non-owner occupied residential	48,806	49,315
Acquisition and development:		
1-4 family residential construction	5,883	5,924
Commercial and land development	26,239	24,237
Commercial and industrial	48,742	48,995
Municipal	60,661	61,191
Residential mortgage:		
First lien	125,752	126,491
Home equity - term	19,912	20,845
Home equity - lines of credit	94,623	89,366
Installment and other loans	5,872	5,891
	\$ 727,753	\$ 704,946

In order to monitor ongoing risk associated with its loan portfolio and specific loans within the segments, management uses an internal grading system. The first several rating categories, representing the lowest risk to the Bank, are combined and given a "Pass" rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including special mention, substandard, doubtful or loss. 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

classified rating. "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"

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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 have 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 identify and manage risk in the lending function. The Enterprise Risk Management (“ERM”) Committee, comprised of senior officers and credit department personnel, is charged with the oversight of overall credit quality and risk exposure of the Bank’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 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.

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of \$1,000,000, which includes confirmation of risk rating by the Credit Administration department. In addition, all relationships greater than \$250,000 rated Substandard, Doubtful or Loss are reviewed by the ERM Committee on a quarterly basis, with reaffirmation of the rating as approved by the Bank’s Problem Loan Committee.

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The following summarizes the Bank's ratings based on its internal risk rating system as of March 31, 2015 and December 31, 2014:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
<b>March 31, 2015</b>						
Commercial real estate:						
Owner-occupied	\$ 100,189	\$ 2,529	\$ 5,457	\$ 3,224	\$ 0	\$ 111,399
Non-owner occupied	128,162	13,700	7,424	414	1,221	150,921
Multi-family	25,547	1,367	1,308	721	0	28,943
Non-owner occupied residential	43,174	2,870	1,800	962	0	48,806
Acquisition and development:						
1-4 family residential construction	5,883	0	0	0	0	5,883
Commercial and land development	24,352	230	1,319	338	0	26,239
Commercial and industrial	43,679	958	1,889	2,216	0	48,742
Municipal	60,661	0	0	0	0	60,661
Residential mortgage:						
First lien	120,619	0	0	5,133	0	125,752
Home equity - term	19,751	0	0	161	0	19,912
Home equity - lines of credit	93,272	654	127	570	0	94,623
Installment and other loans	5,848	0	0	24	0	5,872
	\$ 671,137	\$ 22,308	\$ 19,324	\$ 13,763	\$ 1,221	\$ 727,753
<b>December 31, 2014</b>						
Commercial real estate:						
Owner-occupied	\$ 89,815	\$ 2,686	\$ 5,070	\$ 3,288	\$ 0	\$ 100,859
Non-owner occupied	120,829	20,661	1,131	1,680	0	144,301
Multi-family	24,803	1,086	1,322	320	0	27,531
Non-owner occupied residential	43,020	2,968	1,827	1,500	0	49,315
Acquisition and development:						
1-4 family residential construction	5,924	0	0	0	0	5,924
Commercial and land development	22,261	233	1,333	410	0	24,237
Commercial and industrial	43,794	850	1,914	2,437	0	48,995
Municipal	61,191	0	0	0	0	61,191
Residential mortgage:						
First lien	121,160	9	0	5,290	32	126,491
Home equity - term	20,775	0	0	70	0	20,845
Home equity - lines of credit	88,164	630	93	479	0	89,366
Installment and other loans	5,865	0	0	26	0	5,891
	\$ 647,601	\$ 29,123	\$ 12,690	\$ 15,500	\$ 32	\$ 704,946

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 deemed impaired. 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 to determine if the loan should be placed on nonaccrual status. Nonaccrual loans in the commercial and



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commercial real estate portfolios and any TDRs 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 are incorporated into the impairment analysis as of the next reporting period.

Loan charge-offs, which may include partial charge-offs, 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. Generally, 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 March 31, 2015 and December 31, 2014, nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the loan, except for TDRs. By definition, TDRs are considered impaired. All restructured loan impairments were determined based on discounted cash flows for those loans classified as TDRs but that are still accruing interest. 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. According to policy, updated appraisals are required annually for classified loans in excess of \$250,000. 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 are 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 property's 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 ratio (generally 70% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the Credit Administration staff that there has not been a significant deterioration in the collateral value, the original certified appraised value may 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 consist of 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 loan is one that is inadequately protected by the 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 loans, does not have to exist in individual extensions of credit classified as substandard. As a result, the Company's methodology includes an evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated "Substandard" to be collectively evaluated 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

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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 homogeneous loans are collectively evaluated for impairment. Generally, 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.

The following table 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 March 31, 2015 and December 31, 2014. The recorded investment in loans excludes accrued interest receivable due to insignificance. Allowances established generally pertain to those loans in which loan forbearance agreements were in the process of being negotiated or updated appraisals were pending, and the partial charge-off will be recorded when final information is received.

(Dollars in thousands)	Impaired Loans with a Specific Allowance			Impaired Loans with No Specific Allowance	
	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)	Related Allowance	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)
March 31, 2015					
Commercial real estate:					
Owner-occupied	\$0	\$0	\$0	\$ 3,224	\$ 4,548
Non-owner occupied	1,221	1,326	487	415	2,073
Multi-family	408	408	166	313	352
Non-owner occupied residential	0	0	0	962	1,276
Acquisition and development:					
Commercial and land development	0	0	0	338	1,024
Commercial and industrial	0	0	0	2,216	2,307
Residential mortgage:					
First lien	1,241	1,289	142	3,892	4,379
Home equity - term	0	0	0	160	163
Home equity - lines of credit	0	0	0	570	772
Installment and other loans	12	12	12	12	36
	\$2,882	\$ 3,035	\$807	\$ 12,102	\$ 16,930
December 31, 2014					
Commercial real estate:					
Owner-occupied	\$0	\$0	\$0	\$ 3,288	\$ 4,558
Non-owner occupied	0	0	0	1,680	3,420
Multi-family	0	0	0	320	356
Non-owner occupied residential	198	203	2		