FIRST NATIONAL COMMUNITY BANCORP INC
Form 10-Q
August 11, 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 June 30, 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 No. 000-53869

FIRST NATIONAL COMMUNITY BANCORP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania	**23-2900790**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
102 E. Drinker St., Dunmore, PA	**18512**
(Address of Principal Executive Offices)	(Zip Code)

Registrant’s telephone number, including area code **(570) 346-7667**

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO o

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

Large Accelerated Filer ¨ Accelerated Filer ¨

Non-Accelerated Filer x Smaller reporting company ¨

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

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

Common Stock, $1.25 par value	**16,457,169 shares**
(Title of Class)	(Outstanding at August 11, 2014)

Contents

Part I - Financial Information

Item 1 - Financial Statements

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(unaudited)

(in thousands, except share data)	June 30, 2014	December 31, 2013
Assets		
Cash and cash equivalents:		
Cash and due from banks	$21,429	$19,295
Interest-bearing deposits in other banks	9,220	84,261
Total cash and cash equivalents	30,649	103,556
Securities available for sale at fair value	209,264	203,867
Securities held to maturity at amortized cost (fair value $0 and $2,424)	-	2,308
Stock in Federal Home Loan Bank of Pittsburgh, at cost	4,339	2,146
Loans held for sale	424	820
Loans, net of allowance for loan and lease losses of $12,175 and $14,017	658,802	629,880
Bank premises and equipment, net	11,338	15,363
Accrued interest receivable	2,272	2,191
Intangible assets	385	467
Bank-owned life insurance	28,498	28,167
Other real estate owned	3,182	4,246
Other assets	8,722	10,797
Total assets	$957,875	$1,003,808
Liabilities		
Deposits:		
Demand (non-interest-bearing)	$125,578	$157,550
Interest-bearing	644,660	727,148
Total deposits	770,238	884,698
Borrowed funds		
Federal Home Loan Bank of Pittsburgh advances	77,378	27,123
Subordinated debentures	25,000	25,000
Junior subordinated debentures	10,310	10,310
Total borrowed funds	112,688	62,433
Accrued interest payable	9,953	8,732

Other liabilities	15,790	14,367
Total liabilities	908,669	970,230
Shareholders' equity		
Preferred Shares ($1.25 par)		
Authorized: 20,000,000 shares at June 30, 2014 and December 31, 2013		
Issued and outstanding: 0 shares at June 30, 2014 and December 31, 2013	-	-
Common Shares ($1.25 par)		
Authorized: 50,000,000 shares at June 30, 2014 and December 31, 2013		
Issued and outstanding: 16,471,569 shares at June 30, 2014 and December 31, 2013	20,589	20,589
Additional paid-in capital	61,664	61,627
Accumulated deficit	(35,453)	(45,546)
Accumulated other comprehensive income (loss)	2,406	(3,092)
Total shareholders' equity	49,206	33,578
Total liabilities and shareholders' equity	$957,875	$1,003,808

The accompanying notes to consolidated financial statements are an integral part of these statements.

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except share data)	2014	2013	2014	2013
Interest income				
Interest and fees on loans	$6,612	$6,718	$13,106	$13,325
Interest and dividends on securities				
U.S. government agencies	860	479	1,603	902
State and political subdivisions, tax-free	560	824	1,270	1,831
State and political subdivisions, taxable	97	98	195	197
Other securities	76	34	132	69
Total interest and dividends on securities	1,593	1,435	3,200	2,999
Interest on interest-bearing deposits and federal funds sold	13	14	36	53
Total interest income	8,218	8,167	16,342	16,377
Interest expense				
Interest on deposits	819	1,070	1,684	2,188
Interest on borrowed funds				
Interest on Federal Home Loan Bank of Pittsburgh advances	113	128	209	254
Interest on subordinated debentures	568	569	1,131	1,131
Interest on junior subordinated debentures	50	51	99	102
Total interest on borrowed funds	731	748	1,439	1,487
Total interest expense	1,550	1,818	3,123	3,675
Net interest income before credit for loan and lease losses	6,668	6,349	13,219	12,702
Credit for loan and lease losses	(4,005)	(2)	(5,575)	(1,226)
Net interest income after credit for loan and lease losses	10,673	6,351	18,794	13,928
Non-interest income				
Deposit service charges	746	723	1,436	1,401
Net gain on the sale of securities	1,480	899	3,048	1,741
Net gain on the sale of mortgage loans held for sale	91	50	166	160
Net loss on the sale of education loans	-	-	(13)	-
Net gain on the sale of other real estate owned	39	76	68	89
Gain on branch divestitures	-	-	607	-
Loan-related fees	98	89	191	197
Income from bank-owned life insurance	164	183	331	355
Legal settlements	2,127	-	2,127	-
Other	217	261	454	797
Total non-interest income	4,962	2,281	8,415	4,740
Non-interest expense				
Salaries and employee benefits	3,093	3,243	6,493	6,563
Occupancy expense	472	550	1,116	1,134

Equipment expense	357	380	713	756
Advertising expense	136	179	244	256
Data processing expense	526	504	1,048	1,068
Regulatory assessments	450	610	1,123	1,260
Bank shares tax	175	241	351	482
Expense of other real estate owned	1,818	232	1,981	450
Credit for off-balance sheet commitments	(91)	(55)	(204)	(176)
Legal expense	513	566	1,160	1,181
Professional fees	484	326	934	877
Insurance expenses	279	296	561	619
Loan collection expense	8	20	37	247
Other operating expenses	745	820	1,399	1,500
Total non-interest expense	8,965	7,912	16,956	16,217
Income before income taxes	6,670	720	10,253	2,451
Provision for income taxes	90	-	160	-
Net income	$6,580	$720	$10,093	$2,451
Earnings per share				
Basic	$0.40	$0.04	$0.61	$0.15
Diluted	$0.40	$0.04	$0.61	$0.15
Cash dividends declared per common share	$-	$-	$-	$-
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic	16,471,569	16,457,169	16,471,569	16,457,169
Diluted	16,471,569	16,457,169	16,471,569	16,457,169

The accompanying notes to consolidated financial statements are an integral part of these statements.

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2014	2013	2014	2013
Net income	$ 6,580	$ 720	$ 10,093	$ 2,451
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale	4,606	(8,195)	11,010	(10,138)
Taxes	(1,566)	2,786	(3,743)	3,447
Net of tax amount	3,040	(5,409)	7,267	(6,691)
Reclassification adjustment for gains included in net income	(1,480)	(899)	(2,680)	(1,741)
Taxes	503	306	911	592
Net of tax amount	(977)	(593)	(1,769)	(1,149)
Total other comprehensive income (loss)	2,063	(6,002)	5,498	(7,840)
Total comprehensive income (loss)	$ 8,643	$ (5,282)	$ 15,591	$ (5,389)

The accompanying notes to consolidated financial statements are an integral part of these statements.

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Six Months Ended June 30, 2014 and 2013

(Unaudited)

(in thousands, except per share data)	Number of Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, December 31, 2012	16,457,169	$ 20,571	$ 61,584	$ (51,928)	$ 6,698	$ 36,925
Net income for the period	-	-	-	2,451	-	2,451
Other comprehensive loss, net of tax of $4,039	-	-	-	-	(7,840)	(7,840)
Balances, June 30, 2013	16,457,169	$ 20,571	$ 61,584	$ (49,477)	$ (1,142)	$ 31,536
Balances, December 31, 2013	16,471,569	$ 20,589	$ 61,627	$ (45,546)	$ (3,092)	$ 33,578
Net income for the period	-	-	-	10,093	-	10,093
Restricted stock awards	-	-	37	-	-	37
Other comprehensive income, net of tax of $2,832	-	-	-	-	5,498	5,498
Balances, June 30, 2014	16,471,569	$ 20,589	$ 61,664	$ (35,453)	$ 2,406	$ 49,206

The accompanying notes to consolidated financial statements are an integral part of these statements.

FIRST NATIONAL COMMUNITY BANCORP, INC AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)	Six Months Ended June 30, 2014	2013
Operating activities:		
Net income	$10,093	$2,451
Adjustments to reconcile net income to net cash provided by operating activities:		
Investment securities amortization (accretion), net	622	(55)
Equity in trust	(3)	(3)
Depreciation and amortization	721	618
Stock-based compensation	37	-
Credit for loan and lease losses	(5,575)	(1,226)
Credit for off balance sheet commitments	(204)	(176)
Gain on the sale of available-for-sale securities	(2,680)	(1,741)
Gain on the sale of held-to-maturity securities	(368)	-
Valuation adjustment, loans held for sale	-	26
Gain on the sale of loans held for sale	(166)	(186)
Loss on the sale of education loans	13	-
Gain on branch divestitures	(607)	-
Gain on the sale of other real estate owned	(68)	(89)
Valuation adjustment of other real estate owned	1,770	105
Income from bank-owned life insurance	(331)	(355)
Proceeds from the sale of loans held for sale	5,077	6,724
Funds used to originate loans held for sale	(4,515)	(5,854)
Increase in accrued interest receivable	(81)	(238)
Decrease in other assets	341	4,374
Increase in accrued interest payable	1,221	1,159
Increase (decrease) in other liabilities	400	(956)
Total adjustments	(4,396)	2,127
Net cash provided by operating activities	5,697	4,578
Cash flows from investing activities:		
Maturities, calls, and principal payments of available-for-sale securities	3,541	8,459
Proceeds from the sale of available-for-sale securities	38,569	40,177
Proceeds from the sale of held-to-maturity securities	2,686	-
Purchases of available-for-sale securities	(37,129)	(73,997)
Net (purchase) redemption of Federal Home Loan Bank of Pittsburgh stock	(2,193)	2,416
Proceeds from the sale of education loans	2,537	-
Net increase in loans to customers	(25,766)	(43,027)
Proceeds from the sale of other real estate owned	1,113	1,348
Proceeds from the sale of bank premises and equipment through branch divestitures	2,504	-

Purchases of property and equipment	(687)	(266)
Net cash used in investing activities	(14,825)	(64,890)
Cash flows from financing activities:		
Net decrease in deposits	(114,034)	(24,914)
Proceeds from Federal Home Loan Bank of Pittsburgh advances	89,935	10,000
Repayment of Federal Home Loan Bank of Pittsburgh advances	(39,680)	(6,292)
Net cash used in financing activities	(63,779)	(21,206)
Net decrease in cash and cash equivalents	(72,907)	(81,518)
Cash and cash equivalents at beginning of period	103,556	115,271
Cash and cash equivalents at end of period	$30,649	$33,753
Supplemental cash flow information		
Cash paid during the period for:		
Interest	$1,902	$2,516
Income taxes	115	-
Other transactions:		
Principal balance of loans transferred to other real estate owned	13	159
Bank premises transferred to other real estate owned	1,749	-
Change in deferred gain on sale of other real estate owned	12	-

The accompanying notes to consolidated financial statements are an integral part of these statements.

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FIRST NATIONAL COMMUNITY BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Notes to Consolidated Financial Statements

Note 1. Basis of Presentation

The consolidated financial statements are comprised of the accounts of First National Community Bancorp, Inc., and its wholly owned subsidiary, First National Community Bank (the “Bank”), as well as the Bank’s wholly owned subsidiaries (collectively, the “Company”). The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and general practices within the banking industry. In the opinion of management, all adjustments necessary for a fair presentation of the results for the three and six month periods ended June 30, 2014 have been included in the consolidated financial statements. All intercompany balances and transactions have been eliminated in consolidation. Prior period amounts have been reclassified when necessary to conform to the current period’s presentation. These reclassifications did not have an impact on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and six months ended June 30, 2014, may not be indicative of its future results of operations and financial position.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to change in the near term are the allowance for loan and lease losses (“ALLL”), investment security valuations, the evaluation of investment securities and other real estate owned (“OREO”) for impairment, and the evaluation of deferred income taxes.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s audited financial statements, included in its Annual Report filed on Form 10-K as of and for the year ended December 31, 2013 and the Company’s Quarterly Report filed on Form 10-Q for the three months ended March 31, 2014.

Note 2. New Authoritative Accounting Guidance

ASU 2013-11, Income Taxes (Topic 740): “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists,” requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. If a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date, the unrecognized tax benefit should be presented in the financial statements as a liability and not combined with deferred tax assets. The Company adopted ASU 2013-11 on January 1, 2014. The adoption of this new guidance did not have an effect on the operating results or financial position of the Company.

Accounting Guidance to be Adopted in Future Periods

ASU 2014-04, Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure,” 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 (a) the creditor obtaining legal title to residential real estate property upon completion of a foreclosure or (b) 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 the amount of foreclosed residential real estate property held by the creditor and 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. This guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014, with early adoption permitted. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,” changes the criteria for reporting a discontinued operation. Under the new guidance, a disposal of a component of an entity or group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on the entity’s operations and financial results. This new guidance reduces complexity by removing the complex and extensive implementation guidance and illustrations that are necessary to apply the current definition of a discontinued operation. The new guidance also requires expanded disclosures about discontinued operations that will provide users with more information about the assets, liabilities, revenues and expenses of a discontinued operation and will require pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting, which will provide users with information about the ongoing trends in a reporting organization’s results from continuing operations. A public company or not-for-profit organization that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market is required to apply the new guidance prospectively to all disposals (or classifications as held for sale) of components of an organization and all business or nonprofit activities that, on acquisition, are classified as held for sale that occur within annual periods beginning on or after December 15, 2014, and interim periods within those years. The adoption of this guidance on January 1, 2015 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-09, Revenue from Contracts with Customers (Topic 606): Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs-Contract with Customers (Subtopic 340-40);” Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and Section C, “Background Information and Basis for Conclusions,” provides a robust framework for addressing revenue recognition issues, upon its effective date, replaces almost all existing revenue recognition guidance, including industry specific guidance, in current GAAP. The core principle of ASU 2014-09 is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced interim and annual disclosures, both qualitative and quantitative, about revenue in order to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. ASU 2014-09 is effective in annual reporting periods beginning after December 15, 2016 and the interim periods within that year for public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or over-the-counter market and employee benefit plans that file or furnish financial statements to the SEC. Accordingly, the Company will adopt this guidance on January 1, 2017 and is currently evaluating the effect this guidance may have on its operating results or financial position.

ASU 2014-11, Transfers and Servicing (Topic 860): “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures,” changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements by aligning the accounting for these transactions with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial assets and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward arrangement, which has resulted in outcomes referred to as off-balance sheet accounting. ASU 2014-11 also requires a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction, and requires expanded disclosure about the nature of the collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. Accounting changes in ASU 2014-11 are effective for public companies for interim and annual periods beginning after December 15, 2014. In addition, the disclosure for certain transactions accounted for as a sale is effective for the first interim or annual period beginning on or after December 15, 2014, and the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. The adoption of this guidance on the appropriate effective dates is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-12, Compensation – Stock Compensation (Topic 718): “Accounting for Share-Based Payments When the Terms of an Award Provide that a Performance Target Could be Achieved after the Requisite Service Period,” requires a performance target that affects vesting and that can be achieved after the requisite service period to be treated as a performance condition. To account for such awards, an entity should apply existing guidance as it relates to awards with performance conditions that affect vesting. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service periods. The total amount of compensation cost should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

Note 3. Regulatory Matters

The Bank is under a Consent Order (the “Order”) from the Office of the Comptroller of the Currency (“OCC”) dated September 1, 2010. The Company is also subject to a Written Agreement (the “Agreement”) with the Federal Reserve Bank of Philadelphia (the “Reserve Bank”) dated November 24, 2010.

OCC Consent Order. The Bank, pursuant to a Stipulation and Consent to the Issuance of a Consent Order dated September 1, 2010, without admitting or denying any wrongdoing, consented and agreed to the issuance of the Order by the OCC, the Bank's primary regulator. The Order requires the Bank to undertake certain actions within designated timeframes, and to operate in compliance with the provisions thereof during its term. The Order is based on the results of an examination of the Bank as of March 31, 2009. Since the examination, management has engaged in ongoing discussions with the OCC and has taken steps to improve the condition, policies and procedures of the Bank. Compliance with the Order is monitored by a committee (the "Committee") of at least three directors, none of whom is an employee or controlling shareholder of the Bank or its affiliates or a family member of any such person. The Committee had been required to submit written progress reports to the OCC on a monthly basis. Effective April 10, 2014, the written progress report requirement was changed from monthly to quarterly as of quarter-end March 31, 2014. The Committee has submitted each of the required progress reports with the OCC. The members of the Committee are John P. Moses, William G. Bracey, Joseph Coccia, Joseph J. Gentile and Thomas J. Melone. The material provisions of the Order are set forth below with a description of the status of the Bank's effort to comply with such provisions:

(i) By October 31, 2010, the Board of Directors of the Bank (the "Board") was required to adopt and implement a three-year strategic plan (a "Strategic Plan") which must be submitted to the OCC for review and prior determination of no supervisory objection; the Strategic Plan must establish objectives for the Bank's overall risk profile, earnings performance, growth, balance sheet mix, off-balance sheet activities, liability structure, capital adequacy, reduction in the volume of nonperforming assets, product line development, and market segments that the Bank intends to promote or develop, and is to include strategies to achieve those objectives; if the Strategic Plan involves the sale or merger of the Bank, it must address the timeline and steps to be followed to provide for a definitive agreement within 90 days after the receipt of a determination of no supervisory objection;

The Bank has developed a Strategic Plan that it believes complies with the Order requirements. A three-year Strategic Plan for the period January 1, 2011 to December 31, 2013 was prepared and submitted to the OCC for review. On an annual basis, the Bank prepares an updated and revised Strategic Plan. Strategic Plans for the three-year periods January 1, 2012 to December 31, 2014 and January 1, 2013 to December 31, 2015 were submitted to the OCC for review. The Strategic Plan for the three-year period January 1, 2014 to December 31, 2016 was completed and submitted to the OCC for review in April 2014. The OCC issued a written determination of supervisory non-objection to the Strategic Plan in June 2014.

(ii) by October 31, 2010, the Board was required to adopt and implement a three year capital plan (a "Capital Plan"), which must be submitted to the OCC for review and prior determination of no supervisory objection;

The Bank has developed a Capital Plan that it believes complies with the Order requirements to ensure that the Bank's leverage ratio equals or exceeds 9% and the Bank's total risk-based capital ratio equals or exceeds 13%. This Capital Plan for the period January 1, 2011 through December 31, 2013 and its annual update and revisions for 2012 and 2013 were submitted to the OCC for review. The annual update and revision to the Capital Plan for the three-year period January 1, 2014 to December 31, 2016 was completed and forwarded to the OCC for review in April 2014. The OCC issued a written determination of supervisory non-objection to the Capital Plan in June 2014.

(iii) by November 30, 2010, the Bank was required to achieve and thereafter maintain a total risk-based capital equal to at least 13% of risk-weighted assets and a Tier 1 capital equal to at least 9% of adjusted total assets;

The Bank’s total risk-based capital ratio was 14.74% at June 30, 2014, which was above the 13.00% required by the Order. The Bank’s leverage capital ratio was 9.62% at June 30, 2014, which was above the 9.00% required by the Order. The Bank’s total risk-based capital increased 131 basis points, while the Bank’s leverage ratio increased 130 basis points at June 30, 2014 compared to December 31, 2013. The Bank continues to execute its Capital Plan and has engaged an outside financial advisory firm to assist the Bank in taking appropriate actions to achieve and maintain compliance with the capital requirements of the Order. Appropriate actions or combinations of actions may include capital accretion through current earnings, raising additional capital, reducing the Bank’s assets through sales of branch offices, loans or other real estate owned, or pursuing other strategic transactions.

(iv) the Bank may not pay any dividend or capital distribution unless it is in compliance with the higher capital requirements required by the Order, the Capital Plan, applicable legal requirements and, then only after receiving a determination of no supervisory objection from the OCC;

The Board has acknowledged the prohibition on payment of dividends or any other capital distributions without the prior written consent of the OCC. The Bank has not paid any dividends or capital distributions since the effective date of the Order.

(v) by November 15, 2010, the Committee must have reviewed the Board and the Board’s committee structure; by November 30, 2010, the Board was required to prepare or cause to be prepared an assessment of the capabilities of the Bank’s executive officers to perform their past and current duties, including those required to respond to the most recent examination report, and to perform annual performance appraisals of each officer;

The Committee completed its review of the Board and the Board committee structure on November 10, 2010 by reviewing the Board Structure Study report completed by an independent consultant engaged by the Committee. The report was forwarded to the OCC on November 24, 2010. The Company is in the process of implementing those recommendations and believes it is in compliance with the requirements of this provision. Louis A. DeNaples re-joined the Board in December 2013 and William G. Bracey was appointed to the Board in May 2014.

The Board completed its assessment of the capabilities of the Bank’s executive officers upon receipt of a management study, completed by an independent consultant (the “Management Study”), on October 13, 2010. The Management Study was forwarded to the OCC on October 29, 2010. The Board of Directors completed a successful search for President and Chief Executive Officer in December 2011. Since the effective date of the Order, other changes have been made to the executive management team related to the size and complexity of the organization. The Board believes that it has prepared or caused to be prepared an assessment of the capabilities of the Bank’s executive officers to perform their past and current duties, including those required to respond to the most recent examination report.

Annual performance appraisals are prepared for each officer based on established and timely management goals to confirm that each officer is performing the duties outlined in his or her job description.

(vi) by October 31, 2010, the Board was required to adopt, implement and thereafter ensure compliance with a comprehensive Conflict of Interest Policy applicable to the Bank’s and the Company’s directors, executive officers, principal shareholders and their affiliates and such person’s immediate family members and their related interests, employees, and by November 30, 2010, was required to review existing relationships with such persons to identify those, if any, not in compliance with the policy; and review all subsequent proposed transactions with such persons or modifications of transactions;

The Bank’s Conflict of Interest Policy has been revised to provide comprehensive guidance and a review was conducted of existing relationships to ensure compliance with the Conflict of Interest Policy. The revised policy was approved by the Board on September 29, 2010 and forwarded to the OCC on October 7, 2010. Additional revisions were approved by the Board on April 29, 2011, October 24, 2012, May 22, 2013 and November 14, 2013. The Board believes that is has adopted, implemented and maintained compliance with a comprehensive Conflict of Interest Policy in accordance with the requirements of the provision.

(vii) by October 31, 2010, the Board was required to develop, implement and ensure adherence to policies and procedures for Bank Secrecy Act (“BSA”) compliance; and account opening and monitoring procedures compliance;

The Board believes it has developed and implemented a written program of policies and procedures to provide for compliance with the requirements of the BSA as well as compliance with account opening and monitoring procedures.

(viii) by October 31, 2010, the Board was required to ensure the BSA audit function is supported by an adequately staffed department or third party firm; to adopt, implement and ensure compliance with an independent BSA audit; and to assess the capabilities of the BSA officer and supporting staff to perform present and anticipated duties;

The Board believes that the Bank’s BSA audit function is adequately staffed; and the BSA officer and staff have been assessed to determine their ability to implement and maintain compliance with the BSA policies and programs detailed above.

(ix) by October 31, 2010, the Board was required to adopt, implement and ensure adherence to a written credit policy (the “Loan Policy”), including specified features, to improve the Bank’s loan portfolio management;

The Bank’s written Loan Policy has been revised to improve guidance and control over the Bank’s lending functions. The revised policy was approved by the Board on October 27, 2010. Additional periodic Loan Policy revisions were approved by the Board from November 24, 2010 through July 2014 to for purposes of continued compliance with this provision.

(x) the Board was required to take certain actions to resolve certain credit and collateral exceptions;

The Board believes that it has taken action to appropriately address the credit and collateral exceptions concerns detailed in the Order.

(xi) by October 31, 2010, the Board was required to establish an effective, independent and ongoing loan review system to review, at least quarterly, the Bank’s loan and lease portfolios to assure the timely identification and categorization of problem credits; by October 31, 2010, to adopt and adhere to a program for the maintenance of an adequate ALLL, and to review the adequacy of the Bank’s ALLL at least quarterly;

The Board has established an independent and ongoing loan review program on a quarterly basis that it believes provides for the timely identification and categorization of problem credits.

The ALLL policy and methodologies have been reviewed and revised to determine the appropriate level of the ALLL, including documenting the analysis in accordance with GAAP and other applicable regulatory guidelines. The revised policy was approved by the Board on October 27, 2010 and is updated on an annual basis. The Board reviews the ALLL methodology analysis on a quarterly basis as part of the financial reporting process.

(xii) by October 31, 2010, the Board was required to adopt and the Bank implement and adhere to a program to protect the Bank’s interest in criticized assets; and the Bank may only extend additional credit (including renewals) to a borrower whose loans are criticized under specified circumstances;

The Board committed to a program to reduce the Bank’s risk exposure to criticized assets by implementing a detailed monthly reporting and monitoring process. The Board believes that this program has resulted in a substantial reduction in criticized assets.

In accordance with the requirements of the Order, since the date of the Order, the Bank has not extended any additional credit to, or for the benefit of, any borrower who has a loan or other extension of credit that either has been charged off or criticized without the prior approval of the Bank’s Board, or loan committee under specified circumstances, since the date of the Order.

(xiii) by October 31, 2010, the Board was required to adopt and ensure adherence to action plans for each piece of other real estate owned;

The Board committed to action plans for each piece of other real estate owned centered around a robust reporting and monitoring process. The Board believes that this program has resulted in a substantial reduction in other real estate owned balances.

(xiv) by November 30, 2010, the Board was required to develop, implement and ensure adherence to a policy for effective monitoring and management of concentrations of credit;

The Board believes it developed and implemented a written concentration management program consistent with OCC Bulletin 2006-46 on November 24, 2010. This program was forwarded to the OCC on November 30, 2010. Loan concentration analysis reports are prepared and reviewed quarterly by the Board as part of the Bank’s loan portfolio management practices.

(xv) by October 31, 2010, the Board was required to revise and implement the Bank’s Other Than Temporary Impairment Policy;

The Board believes that the Other Than Temporary Impairment Policy has been reviewed and revised so that the quarterly other than temporary impairment (“OTTI”) analysis process identifies and measures OTTI in accordance with GAAP and supervisory guidance, including Financial Accounting Standards Board Accounting Standards Codification 320-10-35 (Recognition and Presentation of Other-than-Temporary Impairments), OCC Bulletin 2009-11 dated April 17, 2009, "Other-than-Temporary Impairment Accounting" and OCC Call Report Instructions.

(xvi) by October 31, 2010, the Board was required to take action to maintain adequate sources of stable funding and liquidity and a contingency funding plan; by October 31, 2010, the Board was required to adopt, implement and ensure compliance with an independent, internal audit program;

The Board believes that it has taken action to maintain adequate sources of stable funding and liquidity and developed an appropriate contingency funding plan for the Bank. A liquidity funding policy that addresses liquidity needs, funding sources and contingency funding was approved by the Board on November 24, 2010 and has been implemented and is reviewed and updated annually. Additional policies related to liquidity, funding and contingency funding have since been created and are updated annually since the Order was executed.

The Board believes that it has taken appropriate steps to adopt, implement and comply with an independent adequately staffed internal audit program.

(xvii) take actions to correct cited violations of law; and adopt procedures to prevent future violations and address compliance management.

The Board and management believe that they have taken appropriate action to correct cited violations and adopted procedures designed to prevent future violations and address compliance management.

Federal Reserve Agreement. On November 24, 2010, the Company entered into the Agreement with the Reserve Bank. The Agreement requires the Company to undertake certain actions within designated timeframes, and to operate in compliance with the provisions thereof during its term. The material provisions of the Agreement are set forth below with a description of the status of the Company's efforts to comply with such provisions:

(i) the Company's Board was required to take appropriate steps to fully utilize the Company's financial and managerial resources to serve as a source of strength to the Bank, including taking steps to ensure that the Bank complies with its Consent Order entered into with the OCC;

The Company has taken, and continues to take, steps the Board believes are appropriate to use the Company's financial and managerial resources to serve as a source of strength to the Bank. The steps the Bank has taken to comply with the Order are discussed above.

(ii) the Company may not declare or pay any dividends without the prior written approval of the Reserve Bank and the Director of the Division of Banking Supervision and Regulation (the "Director") of the Federal Reserve Board;

The Company has acknowledged the prohibition on payment of dividends without the prior written consent of the Reserve Bank and Director. The Company has not paid any dividends since the effective date of the Agreement.

(iii) the Company may not take dividends or other payments representing a reduction of the Bank's capital without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on taking dividends or any other capital distributions from the Bank without the prior written consent of the Reserve Bank. The Bank has not paid and the Company has not received any dividends or capital distributions from the Bank since the effective date of the Agreement.

(iv) the Company and its nonbank subsidiary may not make any payment of interest, principal or other amounts on the Company's subordinated debentures or trust preferred securities without the prior written approval of the Reserve Bank and the Director;

The Company has acknowledged the prohibition on any payment related to the Company's subordinated debentures and trust preferred securities without the written approval of the Reserve Bank and Director. The Company has not made any payments of interest, principal or other amounts on the Company's subordinated debentures or trust preferred securities since the effective date of the Agreement.

(v) the Company may not make any payment of interest, principal or other amounts on debt owed to insiders of the Company without the prior written approval of the Reserve Bank and Director;

The Company has acknowledged the prohibition on any payment related to the debt owed to insiders of the Company without the written approval of the Reserve Bank and Director. The Company has not made any payments related to debt owed to insiders since the effective date of the Agreement.

(vi) the Company and its nonbank subsidiary may not incur, increase or guarantee any debt without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on incurring, increasing or guaranteeing any debt without the written approval of the Reserve Bank other than permitted borrowings by the Bank from the Federal Home Loan Bank ("FHLB"). The Company has not incurred, increased or guaranteed any debt since the effective date of the Agreement.

(vii) the Company may not purchase or redeem any shares of its stock without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on purchasing or redeeming any shares of its stock without the written approval of the Reserve Bank. The Company has not purchased or redeemed any shares of its stock since the effective date of the Agreement.

(viii) the Company was required to submit to the Reserve Bank, by January 23, 2011, an acceptable written plan to maintain sufficient capital at the Company on a consolidated basis. Thereafter, the Company must notify the Reserve Bank within 45 days of the end of any quarter in which the Company's capital ratios fall below the approved capital plan's minimum ratios, and submit an acceptable written plan to increase the Company's capital ratios above the capital plan's minimums;

The Company has developed a Capital Plan that it believes is acceptable and maintains sufficient capital at the Company on a consolidated basis. The Capital Plan was submitted to the Reserve Bank on January 11, 2011. The Capital Plan has since been updated at least annually and forwarded to the Reserve Bank. The annual update and revision to the Capital Plan for the three-year period January 1, 2014 to December 31, 2016 was completed in conjunction with the annual budget and strategic planning initiatives and provided to the Reserve Bank in April 2014. The Company notified the Reserve Bank that the OCC issued a written determination of supervisory non-objection to the Capital Plan in June 2014.

The Bank’s total risk-based capital ratio was 14.74% at June 30, 2014, which was above the 13.00% minimum required by the Order. The Bank’s leverage ratio was 9.62% at June 30, 2014, which was also above the 9.00% required by the Order.

(ix) the Company was required to immediately take all actions necessary to ensure that: (1) each regulatory report accurately reflects the Company’s condition on the date for which it is filed and all material transactions between the Company and its subsidiaries; (2) each such report is prepared in accordance with its instructions; and (3) all records indicating how the report was prepared are maintained for supervisory review;

The Company believes that it has taken actions to ensure that all required regulatory reports are filed to accurately reflect its financial condition on the date filed, are prepared in accordance with instructions and that records detailing how the reports were filed are maintained and available for supervisory review.

(x) the Company was required to submit to the Reserve Bank, by January 23, 2011, acceptable written procedures to strengthen and maintain internal controls to ensure all required regulatory reports and notices filed with the Board of Governors are accurate and filed in accordance with the instructions for preparation;

The Company believes that it has designed effective written procedures and strengthened internal controls so that all required Board of Governors reports and notices filed are accurate, timely and in accordance with instructions. The written procedures were provided to the Reserve Bank on January 21, 2011.

(xi) the Company was required to submit to the Reserve Bank, by January 8, 2011, a cash flow projection for 2011, reflecting the Company’s planned sources and uses of cash, and submit a cash flow projection for each subsequent calendar year at least one month prior to the beginning of such year;

The Company created a cash flow projection for 2011 and submitted it to the Reserve Bank on January 7, 2011 in accordance with requirements of the Agreement. Similar projections for 2012, 2013, and 2014 were provided to the Reserve Bank within the time requirements prescribed in the Agreement. The Company provided the Reserve Bank with an updated cash flow projection for 2014-2016 in August of 2013.

(xii) the Company must comply with: (1) the notice provisions of Section 32 of the FDI Act and Subpart H of Regulation Y in appointing any new director or senior executive officer or changing the duties of any senior executive officer; and (2) the restrictions on indemnification and severance payments of Section 18(k) of the FDI Act and Part 359 of the FDIC's regulations;

The Company has acknowledged the notice requirements on the appointment of any new director or senior executive officer. The Company has filed the appropriate notice for each new director or senior executive officer since the date of the Agreement.

The Company acknowledges the restriction on indemnification and severance payments under Section 18(k) of the FDI Act and Part 359 of the FDIC's regulations. The Company has not made any such indemnification or severance payments since the effective date of the Agreement without obtaining prior regulatory non-objection from the OCC and regulatory concurrence from the FDIC as required by Part 359.

(xiii) the Board must submit written progress reports within 30 days of the end of each calendar quarter.

The Company's Board has filed each of the required written progress reports with the Reserve Bank since the Agreement was executed.

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank's regulatory agency. At June 30, 2014, the Company and the Bank are restricted from paying any dividends, without regulatory approval.

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices must be met. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Current quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).

In accordance with the Order, the Bank is required to achieve and thereafter maintain a total risk-based capital ratio equal to at least 13.00% of risk-weighted assets and a Tier I capital ratio equal to at least 9.00% of adjusted total assets. As of June 30, 2014, the Bank met both the 13.00% minimum requirement for the total-risk based capital ratio and the 9.00% minimum requirement for the Tier I leverage ratio. The minimum capital requirements under the Order take precedence over the standard regulatory capital adequacy definitions described in the tables below.

The Company's and the Bank's actual capital positions and ratios at June 30, 2014 and December 31, 2013 are presented in the following table:

Capital Analysis

(in thousands)	June 30, 2014	December 31, 2013
Company		
Tier I capital:		
Total tier I capital	$56,356	$ 46,165
Tier II capital:		
Subordinated notes	25,000	23,085
Allowable portion of allowance for loan losses	8,656	8,462
Total tier II capital	33,656	31,547
Total risk-based capital	90,012	77,712
Total risk-weighted assets	$688,687	$ 670,894
Total average assets (for Tier I leverage ratio)	$964,547	$ 980,754
Bank		

Tier I capital:		
Total tier I capital	$92,808	$ 81,581
Tier II capital:		
Allowable portion of allowance for loan losses	8,652	8,456
Total tier II capital	8,652	8,456
Total risk-based capital	101,460	90,037
Total risk-weighted assets	$688,310	$ 670,416
Total average assets (for Tier I leverage ratio)	$964,651	$ 980,747

The following tables present summary information regarding the Company’s and the Bank’s risk-based capital and related ratios at June 30, 2014 and December 31, 2013:

(dollars in thousands)	Actual Amount	Ratio	For Capital Adequacy Purposes Amount	Ratio	To Be Well Capitalized Under Prompt Corrective Action Provision Amount	Ratio
June 30, 2014						
Total capital (to risk-weighted assets)						
Company	$90,012	13.07 %	$ >55,095	>8.00%	N/A	N/A
Bank	$101,460	14.74 %	$ >55,065	>8.00%	$ >68,831	>10.00%
Tier I capital (to risk-weighted assets)						
Company	$56,356	8.18 %	$ >27,547	>4.00%	N/A	N/A
Bank	$92,808	13.48 %	$ >27,532	>4.00%	$ >41,299	>6.00%
Tier I capital (to average assets)						
Company	$56,356	5.84 %	$ >38,582	>4.00%	N/A	N/A
Bank	$92,808	9.62 %	$ >38,586	>4.00%	$ >48,233	>5.00%

(dollars in thousands)	Actual Amount	Ratio	For Capital Adequacy Purposes Amount	Ratio	To Be Well Capitalized Under Prompt Corrective Action Provision Amount	Ratio
December 31, 2013						
Total capital (to risk-weighted assets)						
Company	$77,712	11.58 %	$>53,672	>8.00%	N/A	N/A
Bank	$90,037	13.43 %	$>53,633	>8.00%	$>67,042	>10.00 %
Tier I capital (to risk-weighted assets)						
Company	$46,165	6.88 %	$>26,836	>4.00%	N/A	N/A
Bank	$81,581	12.17 %	$>26,817	>4.00%	$>40,225	>6.00 %
Tier I capital (to average assets)						
Company	$46,165	4.71 %	$>39,230	>4.00%	N/A	N/A
Bank	$81,581	8.32 %	$>39,230	>4.00%	$>49,038	>5.00 %

Note 4. Loans

The following table summarizes loans receivable, net, by category at June 30, 2014 and December 31, 2013:

(in thousands)	June 30, 2014	December 31, 2013
Residential real estate	$121,922	$ 114,925
Commercial real estate	234,560	218,524
Construction, land acquisition and development	23,858	24,382
Commercial and industrial	130,370	127,021
Consumer	119,854	118,645
State and political subdivisions	39,807	39,875
Total loans, gross	670,371	643,372
Unearned income	(133)	(143)
Net deferred loan fees and costs	739	668
Allowance for loan and lease losses	(12,175)	(14,017)
Loans, net	$658,802	$ 629,880

The Company has granted loans, letters of credit and lines of credit to certain executive officers and directors of the Company as well as to certain related parties of executive officers and directors. These loans, letters of credit and lines of credit were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and, when made, did not involve more than the normal risk of collectability. See Note 10 to these consolidated financial statements for more information about related party transactions.

The Company originates one- to four-family mortgage loans primarily for sale in the secondary market. During the three and six month periods ended June 30, 2014, the Company sold $2.5 and $4.9 million, respectively, of one- to four-family mortgages. The Company retains servicing rights on these mortgages.

The Company had $424 thousand and $820 thousand in loans held-for-sale at June 30, 2014 and December 31, 2013, respectively. All loans held for sale are one- to four-family residential mortgage loans.

The Company sold substantially all of its education loans, which are categorized as consumer loans, to a third party during the six months ended June 30, 2014. The education loans had a recorded investment of $2.6 million at the time of sale. The Company recognized a loss of $13 thousand upon the sale of these loans which is included in non-interest income for the six months ended June 30, 2014.

The Company does not have any lending programs commonly referred to as subprime lending. Subprime lending generally targets borrowers with weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, bankruptcies, or borrowers with questionable repayment capacity as evidenced by low credit scores or high debt-burden ratios.

See Note 2 to the Company’s consolidated financial statements included in the 2013 Form 10-K for information about the risk characteristics related to the Company’s loan segments.

The Company provides for loan losses based on the consistent application of its documented ALLL methodology. Loan losses are charged to the ALLL and recoveries are credited to it. Additions to the ALLL are provided by charges against income based on various factors which, in management’s judgment, deserve current recognition of estimated probable losses. Loan losses are charged-off in the period the loans, or portions thereof, are deemed uncollectible. Generally, the Company will record a loan charge-off (including a partial charge-off) to reduce a loan to the estimated recoverable amount based on its methodology detailed below. The Company regularly reviews the loan portfolio and makes adjustments for loan losses in order to maintain the ALLL in accordance with GAAP. The ALLL consists primarily of the following two components:

(1) Specific allowances are established for impaired loans, which are defined by the Company as all loan relationships with an aggregate outstanding balance greater than $100 thousand that are rated substandard and on non-accrual status, rated doubtful or loss, and all troubled debt restructured loans (“TDRs”). The amount of impairment provided for as an allowance is represented by the deficiency, if any, between the carrying value of the loan and either (a) the present value of expected future cash flows discounted at the loan’s effective interest rate, (b) the loan’s observable market price, or (c) the fair value of the underlying collateral, less estimated costs to sell, for collateral dependent loans. Impaired loans that have no impairment losses are not considered for general valuation

allowances described below. If the Company determines that collection of the impairment amount is remote, the Company will record a charge-off.

(2) General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The Company divides its portfolio into loan segments for loans exhibiting similar characteristics. Loans rated special mention or substandard and accruing, which are embedded in these loan segments, are then separated from these loan segments. These loans are then subject to an analysis placing increased emphasis on the credit risk associated with these specific loans. The Company applies an estimated loss rate to each loan group. The loss rates applied are based on the Company's own historical loss experience based on the loss rate for each segment of loans with similar risk characteristics in its portfolio. In addition, management evaluates and applies certain qualitative or environmental factors that are likely to cause estimated credit losses associated with the Company's existing portfolio to differ from historical experience, which are discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the ALLL that is established, which could have a material negative effect on the Company's operating results or financial condition.

Management makes adjustments for loan losses based on its evaluation of several qualitative and environmental factors, including but not limited to:

- Changes in national, local, and business economic conditions and developments, including the condition of various market segments;
- Changes in the nature and volume of the Company's loan portfolio;
- Changes in the Company's lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
- Changes in the experience, ability and depth of the Company's lending management and staff;

- Changes in the quality of the Company's loan review system and the degree of oversight by the Company’s Board of Directors;
- Changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications;
- The existence and effect of any concentrations of credit and changes in the level of such concentrations;
- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company's current loan portfolio; and
- Analysis of customers’ credit quality, including knowledge of their operating environment and financial condition.

Management evaluates the ALLL based on the combined total of the impaired and general components. Generally, when the loan portfolio increases, absent other factors, the ALLL methodology results in a higher dollar amount of estimated probable losses. Conversely, when the loan portfolio decreases, absent other factors, the ALLL methodology results in a lower dollar amount of estimated probable losses.

Each quarter, management evaluates the ALLL and adjusts the ALLL as appropriate through a provision for loan losses. While the Company uses the best information available to make evaluations, future adjustments to the ALLL may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of its examination process, the OCC periodically reviews the Company’s ALLL. The OCC may require the Company to adjust the ALLL based on its analysis of information available to it at the time of its examination.

The following table summarizes the activity in the ALLL by loan category for the three and six months ended June 30, 2014 and 2013:

	Real Estate						
(in thousands)	Residential Real Estate	Commercial Real Estate	Construction, Land Acquisition and Development	Commercial and Industrial	Consumer	State and Political Subdivisions	Total
Three months ended June 30, 2014:							
Allowance for loan losses:							
Beginning balance, April 1, 2014	$2,114	$ 5,530	$ 875	$ 1,812	$ 1,655	$ 603	$12,589
Charge-offs	(76)	-	-	(127)	(130)	-	(333)
Recoveries	62	349	3,299	63	151	-	3,924
Provisions (credits)	12	(746)	(3,251)	10	5	(35)	(4,005)
Ending balance, June 30, 2014	$2,112	$ 5,133	$ 923	$ 1,758	$ 1,681	$ 568	$12,175

Three months ended June 30, 2013:							
Allowance for loan losses:							
Beginning balance, April 1, 2013	$1,884	$ 8,882	$ 1,676	$ 3,605	$ 1,739	$ 687	$18,473
Charge-offs	(188)	-	-	(83)	(165)	-	(436)
Recoveries	173	64	114	69	133	-	553
Provisions (credits)	276	(1,123)	600	(104)	53	296	(2)
Ending balance, June 30, 2013	$2,145	$ 7,823	$ 2,390	$ 3,487	$ 1,760	$ 983	$18,588
Six months ended June 30, 2014:							
Allowance for loan losses:							
Beginning balance, January 1, 2014	$2,287	$ 6,017	$ 924	$ 2,321	$ 1,789	$ 679	$14,017
Charge-offs	(85)	-	-	(150)	(367)	-	(602)
Recoveries	70	355	3,539	126	245	-	4,335
Provisions (credits)	(160)	(1,239)	(3,540)	(539)	14	(111)	(5,575)
Ending balance, June 30, 2014	$2,112	$ 5,133	$ 923	$ 1,758	$ 1,681	$ 568	$12,175
Six months ended June 30, 2013:							
Allowance for loan losses:							
Beginning balance, January 1, 2013	$1,764	$ 8,062	$ 2,162	$ 4,167	$ 1,708	$ 673	$18,536
Charge-offs	(347)	(48)	(110)	(128)	(359)	-	(992)
Recoveries	181	109	119	1,585	276	-	2,270
Provisions (credits)	547	(300)	219	(2,137)	135	310	(1,226)
Ending balance, June 30, 2013	$2,145	$ 7,823	$ 2,390	$ 3,487	$ 1,760	$ 983	$18,588

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