AUBURN NATIONAL BANCORPORATION, INC
Form 10-Q
August 01, 2014
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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

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period ________ to ________

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**63-0885779**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 N. Gay Street

Auburn, Alabama 36830

(334) 821-9200

(Address and telephone number of principal executive offices)

(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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

Large Accelerated filer ¨	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

Class	Outstanding at July 31, 2014
Common Stock, $0.01 par value per share	3,643,328 shares

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

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PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Unaudited)

(Dollars in thousands, except share data)	**June 30, 2014**	**December 31, 2013**
Assets:		
Cash and due from banks	$ 14,966	$ 13,437
Federal funds sold	43,311	26,965
Interest bearing bank deposits	11,933	13,820
Cash and cash equivalents	70,210	54,222
Securities available-for-sale	276,953	271,219
Loans held for sale	7,200	2,296
Loans, net of unearned income	385,826	383,339
Allowance for loan losses	(4,728)	(5,268)
Loans, net	381,098	378,071
Premises and equipment, net	10,269	10,442
Bank-owned life insurance	17,754	17,503
Other real estate owned	1,584	3,884
Other assets	10,060	13,706
Total assets	$ 775,128	$ 751,343
Liabilities:		
Deposits:		
Noninterest-bearing	$ 130,355	$ 125,740
Interest-bearing	553,826	543,104
Total deposits	684,181	668,844
Federal funds purchased and securities sold under agreements to repurchase	3,316	3,363
Long-term debt	12,217	12,217
Accrued expenses and other liabilities	3,123	2,434
Total liabilities	702,837	686,858
Stockholders equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; no issued shares		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,763	3,759
Retained earnings	73,992	71,879

Accumulated other comprehensive income (loss), net		1,136		(4,552)
Less treasury stock, at cost - 313,807 shares and 314,017 shares at June 30, 2014 and December 31, 2013, respectively		(6,639)		(6,640)
Total stockholders equity		72,291		64,485
Total liabilities and stockholders equity	$	775,128	$	751,343

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

(In thousands, except share and per share data)	Quarter ended June 30, 2014	Quarter ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Interest income:				
Loans, including fees	$ 4,766	$ 5,224	$ 9,556	$ 10,552
Securities:				
Taxable	1,214	899	2,390	1,773
Tax-exempt	607	708	1,234	1,450
Federal funds sold and interest bearing bank deposits	30	29	72	60
Total interest income	6,617	6,860	13,252	13,835
Interest expense:				
Deposits	1,255	1,349	2,512	2,753
Short-term borrowings	5	3	9	7
Long-term debt	104	276	208	702
Total interest expense	1,364	1,628	2,729	3,462
Net interest income	5,253	5,232	10,523	10,373
Provision for loan losses			(400)	400
Net interest income after provision for loan losses	5,253	5,232	10,923	9,973
Noninterest income:				
Service charges on deposit accounts	219	234	432	483
Mortgage lending	348	837	734	1,647
Bank-owned life insurance	125	101	251	196
Other	377	381	715	721
Securities gains, net:				
Realized gains, net	12	518	38	679
Total other-than-temporary impairments			(333)	
Total securities gains (losses), net	12	518	(295)	679
Total noninterest income	1,081	2,071	1,837	3,726
Noninterest expense:				
Salaries and benefits	2,221	2,114	4,502	4,364
Net occupancy and equipment	341	333	693	664
Professional fees	225	209	431	385
FDIC and other regulatory assessments	129	143	274	337
Other real estate owned, net	(62)	20	56	43
Prepayment penalties on long-term debt		1,046		1,471
Other	938	859	1,784	1,686
Total noninterest expense	3,792	4,724	7,740	8,950

Earnings before income taxes	2,542	2,579	5,020	4,749
Income tax expense	683	672	1,340	1,153
Net earnings	$ 1,859	$ 1,907	$ 3,680	$ 3,596
Net earnings per share:				
Basic and diluted	$ 0.51	$ 0.52	$ 1.01	$ 0.99
Weighted average shares outstanding:				
Basic and diluted	3,643,295	3,642,955	3,643,228	3,642,936

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)	Quarter ended June 30, 2014	Quarter ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net earnings	$ 1,859	$ 1,907	$ 3,680	$ 3,596
Other comprehensive income (loss), net of tax:				
Unrealized net holding gain (loss) on securities	2,937	(5,821)	5,502	(6,577)
Reclassification adjustment for net (gain) loss on securities recognized in net earnings	(8)	(327)	186	(428)
Other comprehensive income (loss)	2,929	(6,148)	5,688	(7,005)
Comprehensive income (loss)	$ 4,788	$ (4,241)	$ 9,368	$ (3,409)

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Unaudited)

(Dollars in thousands, except share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
Balance, December 31, 2012	3,957,135	$ 39	$ 3,756	$ 67,821	$ 5,174	$ (6,641)	$ 70,149
Net earnings				3,596			3,596
Other comprehensive loss					(7,005)		(7,005)
Cash dividends paid ($0.42 per share)				(1,530)			(1,530)
Sale of treasury stock (90 shares)			1				1
Balance, June 30, 2013	3,957,135	$ 39	$ 3,757	$ 69,887	$ (1,831)	$ (6,641)	$ 65,211
Balance, December 31, 2013	3,957,135	$ 39	$ 3,759	$ 71,879	$ (4,552)	$ (6,640)	$ 64,485
Net earnings				3,680			3,680
Other comprehensive income					5,688		5,688
Cash dividends paid ($0.43 per share)				(1,567)			(1,567)
Sale of treasury stock (210 shares)			4			1	5
Balance, June 30, 2014	3,957,135	$ 39	$ 3,763	$ 73,992	$ 1,136	$ (6,639)	$ 72,291

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Six Months Ended June 30, 2014	2013
Cash flows from operating activities:		
Net earnings	$ 3,680	$ 3,596
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	(400)	400
Depreciation and amortization	366	448
Premium amortization and discount accretion, net	776	1,143
Net loss (gain) on securities available-for-sale	295	(679)
Net gain on sale of loans held for sale	(494)	(1,258)
Increase (decrease) in MSR valuation allowance	43	(201)
Net loss (gain) on other real estate owned	42	(47)
Loss on prepayment of long-term debt		1,471
Loans originated for sale	(29,459)	(61,382)
Proceeds from sale of loans	24,847	60,225
Increase in cash surrender value of bank owned life insurance	(251)	(196)
Net decrease in other assets	71	1,262
Net increase in accrued expenses and other liabilities	694	916
Net cash provided by operating activities	210	5,698
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	18,354	37,859
Proceeds from maturities of securities available-for-sale	18,127	39,179
Purchase of securities available-for-sale	(34,273)	(99,923)
(Increase) decrease in loans, net	(3,021)	6,159
Net purchases of premises and equipment	(19)	(471)
Decrease in FHLB stock	235	1,153
Proceeds from sale of other real estate owned	2,652	1,999
Net cash provided by (used in) investing activities	2,055	(14,045)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	4,615	9,175
Net increase in interest-bearing deposits	10,722	20,498
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(47)	2,264
Repayments or retirement of long-term debt		(21,471)
Dividends paid	(1,567)	(1,530)
Net cash provided by financing activities	13,723	8,936
Net change in cash and cash equivalents	15,988	589
Cash and cash equivalents at beginning of period	54,222	61,949

Cash and cash equivalents at end of period	$ 70,210	$ 62,538

Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 2,777	$ 3,548
Income taxes	506	254
Supplemental disclosure of non-cash transactions:		
Real estate acquired through foreclosure	394	642

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

Auburn National Bancorporation, Inc. (the Company) provides a full range of banking services to individual and corporate customers in Lee County, Alabama and surrounding counties through its wholly owned subsidiary, AuburnBank (the Bank). The Company does not have any segments other than banking that are considered material.

Basis of Presentation and Use of Estimates

The unaudited consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The unaudited consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company s annual report on Form 10-K for the year ended December 31, 2013.

The unaudited consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Auburn National Bancorporation Capital Trust I is an affiliate of the Company and was included in these unaudited consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include other-than-temporary impairment on investment securities, the determination of the allowance for loan losses, fair value of financial instruments, and the valuation of deferred tax assets and other real estate owned.

Reclassifications

Certain amounts reported in prior periods have been reclassified to conform to the current-period presentation. These reclassifications had no impact on the Company s previously reported net earnings or total stockholders equity.

Subsequent Events

The Company has evaluated the effects of events and transactions through the date of this filing that have occurred subsequent to June 30, 2014. The Company does not believe there were any material subsequent events during this period that would have required further recognition or disclosure in the unaudited consolidated financial statements included in this report.

Accounting Developments

In the first quarter of 2014, the Company adopted new guidance related to the following Accounting Standards Update (Update or ASU):

ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.*

Information about this pronouncement is described in more detail below.

ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists,* is expected to eliminate diversity in practice as it provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward exists. The changes were effective for the Company during the first quarter of 2014. Adoption of this ASU had no impact on the financial statements of the Company.

NOTE 2: BASIC AND DILUTED EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the respective period. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company s common stock. At June 30, 2014 and 2013, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

The basic and diluted earnings per share computations for the respective periods are presented below.

	Quarter ended June 30,		Six Months Ended June 30,	
(In thousands, except share and per share data)	2014	2013	2014	2013
Basic and diluted:				
Net earnings	$ 1,859	$ 1,907	$ 3,680	$ 3,596
Weighted average common shares outstanding	3,643,295	3,642,955	3,643,228	3,642,936
Earnings per share	$ 0.51	$ 0.52	$ 1.01	$ 0.99

NOTE 3: VARIABLE INTEREST ENTITIES

Generally, a variable interest entity (VIE) is a corporation, partnership, trust or other legal structure that does not have equity investors with substantive or proportional voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities.

At June 30, 2014, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, discussed below.

Trust Preferred Securities

The Company owns the common stock of a subsidiary business trust, Auburn National Bancorporation Capital Trust I, which issued mandatorily redeemable preferred capital securities (trust preferred securities) in the aggregate of approximately $7.0 million at the time of issuance. This trust meets the definition of a VIE of which the Company is not the primary beneficiary; the trust s only assets are junior subordinated debentures issued by the Company, which were acquired by the trust using the proceeds from the issuance of the trust preferred securities and common stock. The junior subordinated debentures of approximately $7.2 million are included in long-term debt and the Company s equity interest of $0.2 million in the business trust is included in other assets. Interest expense on the junior subordinated debentures is included in interest expense on long-term debt.

The following table summarizes VIEs that are not consolidated by the Company as of June 30, 2014.

		Liability	
(Dollars in thousands)	Maximum Loss Exposure	Recognized	Classification
Type:			

Trust preferred issuances	N/A	$ 7,217	Long-term debt

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NOTE 4: SECURITIES

At June 30, 2014 and December 31, 2013, respectively, all securities within the scope of ASC 320, *Investments Debt and Equity Securities,* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at June 30, 2014 and December 31, 2013, respectively, are presented below.

(Dollars in thousands)	**1 year or less**	**1 to 5 years**	**5 to 10 years**	**After 10 years**	**Fair Value**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Amortized Cost**
June 30, 2014								
Agency obligations (a)	$	13,306	34,535	22,910	70,751	293	1,914	$ 72,372
Agency RMBS (a)			7,535	133,470	141,005	2,009	1,523	140,519
State and political subdivisions		679	17,898	46,620	65,197	2,977	42	62,262
Total available-for-sale	$	13,985	59,968	203,000	276,953	5,279	3,479	$ 275,153
December 31, 2013								
Agency obligations (a)	$		23,247	21,275	44,522		4,557	$ 49,079
Agency RMBS (a)			8,306	154,052	162,358	976	4,733	166,115
State and political subdivisions		1,735	21,366	41,238	64,339	1,560	459	63,238
Total available-for-sale	$	1,735	52,919	216,565	271,219	2,536	9,749	$ 278,432

(a) Includes securities issued by U.S. government agencies or government sponsored entities.

Securities with aggregate fair values of $137.4 million and $120.5 million at June 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets are cost-method investments. The carrying amounts of cost-method investments were $1.6 million and $1.8 million at June 30, 2014 and December 31, 2013, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (FRB) stock.

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at June 30, 2014 and December 31, 2013, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer, are presented below.

	Less than 12 Months		**12 Months or Longer**		**Total**	
(Dollars in thousands)	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
June 30, 2014:						
Agency obligations	$		42,172	1,914	$ 42,172	1,914
Agency RMBS			67,063	1,523	67,063	1,523
State and political subdivisions	1,892	25	2,290	17	4,182	42

Total	$	1,892	25	111,525	3,454	$ 113,417	3,479
December 31, 2013:							
Agency obligations	$	35,933	3,182	8,590	1,376	$ 44,523	4,558
Agency RMBS		109,774	4,393	7,683	339	117,457	4,732
State and political subdivisions		9,575	459			9,575	459
Total	$	155,282	8,034	16,273	1,715	$ 171,555	9,749

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For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. On a quarterly basis, the Company assesses each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

In determining whether a loss is temporary, the Company considers all relevant information including:

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);
- the historical and implied volatility of the fair value of the security;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency; and
- recoveries or additional declines in fair value subsequent to the balance sheet date.

Agency obligations

The unrealized losses associated with agency obligations were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Agency RMBS

The unrealized losses associated with agency RMBS were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Securities of U.S. states and political subdivisions

The unrealized losses associated with securities of U.S. states and political subdivisions were primarily driven by changes in interest rates and were not due to the credit quality of the securities. Some of these securities are guaranteed by a bond insurer, but management did not rely on the guarantee in making its investment decision. These securities will continue to be monitored as part of the Company s quarterly impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers. As a result, the Company expects to recover the entire amortized cost basis of these securities.

Cost-method investments

At June 30, 2014, cost-method investments with an aggregate cost of $1.6 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company s investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that other-than-temporary impairment charges may occur in the future.

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Other-Than-Temporarily Impaired Securities

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and has recognized the credit component of the loss in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings for credit-impaired debt securities are presented as additions in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell, or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security, the security matures or the security is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities for the respective periods are presented below.

(Dollars in thousands)	**Quarter ended June 30, 2014**	**2013**	**Six Months Ended June 30, 2014**	**2013**
Balance, beginning of period	$	$ 1,257	$	$ 1,257
Reductions:				
Securities fully written down and deemed worthless		500		500
Balance, end of period	$	$ 757	$	$ 757

Other-Than-Temporary Impairment

The following table presents details of the other-than-temporary impairment related to securities.

(Dollars in thousands)	**Quarter ended June 30, 2014**	**2013**	**Six Months Ended June 30, 2014**	**2013**
Other-than-temporary impairment charges				
Debt securities:				
Agency RMBS	$	$	$ 333	$
Total debt securities			333	
Total other-than-temporary impairment charges	$	$	$ 333	$
Other-than-temporary impairment on debt securities:				
Recorded as part of gross realized losses:				
Securities with intent to sell			333	
Total other-than-temporary impairment on debt securities	$	$	$ 333	$

Realized Gains and Losses

The following table presents the gross realized gains and losses on sales and other-than-temporary impairment charges related to securities.

(Dollars in thousands)	**Quarter ended June 30, 2014**	**2013**	**Six Months Ended June 30, 2014**	**2013**

Gross realized gains	$	12	$	524	$	38	$	685
Gross realized losses				(6)				(6)
Other-than-temporary impairment charges						(333)		
Realized gains (losses), net	$	12	$	518	$	(295)	$	679

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NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)		**June 30, 2014**		**December 31, 2013**
Commercial and industrial	$	52,054	$	57,780
Construction and land development		32,461		36,479
Commercial real estate:				
Owner occupied		52,571		56,102
Other		134,670		118,818
Total commercial real estate		187,241		174,920
Residential real estate:				
Consumer mortgage		59,257		57,871
Investment property		43,664		43,835
Total residential real estate		102,921		101,706
Consumer installment		11,686		12,893
Total loans		386,363		383,778
Less: unearned income		(537)		(439)
Loans, net of unearned income	$	385,826	$	383,339

Loans secured by real estate were approximately 83.5% of the Company s total loan portfolio at June 30, 2014. At June 30, 2014, the Company s geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

In accordance with ASC 310, a portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. As part of the Company s quarterly assessment of the allowance, the loan portfolio is disaggregated into the following portfolio segments: commercial and industrial, construction and land development, commercial real estate, residential real estate and consumer installment. Where appropriate, the Company s loan portfolio segments are further disaggregated into classes. A class is generally determined based on the initial measurement attribute, risk characteristics of the loan, and an entity s method for monitoring and determining credit risk.

The following describe the risk characteristics relevant to each of the portfolio segments and classes.

Commercial and industrial (C&I) includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower.

Construction and land development (C&D) includes both loans and credit lines for the purpose of purchasing, carrying and developing land into commercial developments or residential subdivisions. Also included are loans and lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

Commercial real estate (CRE) includes loans disaggregated into two classes: (1) owner occupied and (2) other.

Owner occupied includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.

Other primarily includes loans to finance income-producing commercial and multi-family properties that are not owner occupied. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, warehouses and apartments leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.

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Residential real estate (RRE) includes loans disaggregated into two classes: (1) consumer mortgage and (2) investment property.

Consumer mortgage primarily includes first or second lien mortgages and home equity lines of credit to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history and property value.

Investment property primarily includes loans to finance income-producing 1-4 family residential properties. Generally the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates and property value, as well as the financial health of the borrower.

Consumer installment includes loans to individuals both secured by personal property and unsecured. Loans include personal lines of credit, automobile loans, and other retail loans. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history, and if applicable, property value.

The following is a summary of current, accruing past due and nonaccrual loans by portfolio segment and class as of June 30, 2014, and December 31, 2013.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
June 30, 2014:						
Commercial and industrial	$ 51,725	277		52,002	52	$ 52,054
Construction and land development	31,306	192		31,498	963	32,461
Commercial real estate:						
Owner occupied	52,295			52,295	276	52,571
Other	134,460			134,460	210	134,670
Total commercial real estate	186,755			186,755	486	187,241
Residential real estate:						
Consumer mortgage	57,582	715	71	58,368	889	59,257
Investment property	43,133	117		43,250	414	43,664
Total residential real estate	100,715	832	71	101,618	1,303	102,921
Consumer installment	11,576	110		11,686		11,686
Total	$ 382,077	1,411	71	383,559	2,804	$ 386,363
December 31, 2013:						
Commercial and industrial	$ 57,558	167		57,725	55	$ 57,780
Construction and land development	34,883	14		34,897	1,582	36,479
Commercial real estate:						
Owner occupied	54,214	861		55,075	1,027	56,102
Other	118,389			118,389	429	118,818
Total commercial real estate	172,603	861		173,464	1,456	174,920
Residential real estate:						
Consumer mortgage	56,191	745	69	57,005	866	57,871
Investment property	42,935	598		43,533	302	43,835
Total residential real estate	99,126	1,343	69	100,538	1,168	101,706
Consumer installment	12,789	100	4	12,893		12,893
Total	$ 376,959	2,485	73	379,517	4,261	$ 383,778

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal and independent loan review processes. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company s loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company s quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At June 30, 2014 and December 31, 2013, and for the periods then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2014 and 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Beginning with the quarter ended June 30, 2014, the Company calculated average losses for all loan segments using a rolling 20 quarter historical period in order to better capture the effects of the most

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recent economic cycle on the Company s loan loss experience. Beginning with the quarter ended June 30, 2013, the Company calculated average losses for all loan segments using a rolling 8 quarter historical period (except for the commercial real estate loan segment, which used a 6 quarter historical period) and continued this methodology through March 31, 2014. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period.

If the Company continued to calculate average losses for all loan segments other than commercial real estate using a rolling 8 quarter historical period and for the commercial real estate segment using a rolling 6 quarter historical period, the Company s calculated allowance for loan loss allocation would have decreased by approximately $1.0 million at June 30, 2014. Other than the changes discussed above, the Company has not made any changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

The following table details the changes in the allowance for loan losses by portfolio segment for the respective periods.

						June 30, 2014
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Total**
Quarter ended:						
Beginning balance	$ 482	214	2,493	1,256	266	$ 4,711
Charge-offs	(46)			(41)	(8)	(95)
Recoveries	32	1		74	5	112
Net (charge-offs) recoveries	(14)	1		33	(3)	17
Provision for loan losses	171	692	(580)	(194)	(89)	
Ending balance	$ 639	907	1,913	1,095	174	$ 4,728
Six months ended:						
Beginning balance	$ 386	366	3,186	1,114	216	$ 5,268
Charge-offs	(46)	(236)		(72)	(44)	(398)
Recoveries	36	3	118	91	10	258
Net (charge-offs) recoveries	(10)	(233)	118	19	(34)	(140)
Provision for loan losses	263	774	(1,391)	(38)	(8)	(400)
Ending balance	$ 639	907	1,913	1,095	174	$ 4,728

						June 30, 2013
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Total**
Quarter ended:						
Beginning balance	$ 569	1,619	3,571	885	125	6,769
Charge-offs			(118)	(189)	(45)	$ (352)
Recoveries	5	2		28	5	$ 40
Net recoveries (charge-offs)	5	2	(118)	(161)	(40)	(312)
Provision for loan losses	101	(167)	(342)	401	7	$
Ending balance	$ 675	1,454	3,111	1,125	92	$ 6,457
Six months ended:						
Beginning balance	$ 812	1,545	3,137	1,126	103	$ 6,723

Charge-offs	(68)	(39)	(118)	(455)	(62)	(742)
Recoveries	17	3	4	41	11	76
Net charge-offs	(51)	(36)	(114)	(414)	(51)	(666)
Provision for loan losses	(86)	(55)	88	413	40	400
Ending balance	$ 675	1,454	3,111	1,125	92	$ 6,457

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The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of June 30, 2014 and 2013.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
(In thousands)	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
June 30, 2014:						
Commercial and industrial	$ 639	51,959		95	639	52,054
Construction and land development	907	31,498		963	907	32,461
Commercial real estate	1,744	185,302	169	1,939	1,913	187,241
Residential real estate	1,095	102,040		881	1,095	102,921
Consumer installment	174	11,686			174	11,686
Total	$ 4,559	382,485	169	3,878	4,728	386,363
June 30, 2013:						
Commercial and industrial	$ 675	55,882		148	675	56,030
Construction and land development	1,347	44,285	107	1,601	1,454	45,886
Commercial real estate	2,991	174,922	120	2,369	3,111	177,291
Residential real estate	1,069	97,732	56	1,289	1,125	99,021
Consumer installment	92	12,747			92	12,747
Total	$ 6,174	385,568	283	5,407	6,457	390,975

(1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans.
(2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

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Credit Quality Indicators

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for qualitative and environmental factors and are defined as follows:

Pass loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.

Special Mention loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company s position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.

Substandard Accruing loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected

Nonaccrual includes loans where management has determined that full payment of principal and interest is not expected.

(In thousands)		Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
June 30, 2014:						
Commercial and industrial	$	47,157	4,448	397	52	$ 52,054
Construction and land development		30,285	638	575	963	32,461
Commercial real estate:						
Owner occupied		50,904	1,206	185	276	52,571
Other		133,581	89	790	210	134,670
Total commercial real estate		184,485	1,295	975	486	187,241
Residential real estate:						
Consumer mortgage		51,424	3,426	3,518	889	59,257
Investment property		40,702	1,312	1,236	414	43,664
Total residential real estate		92,126	4,738	4,754	1,303	102,921
Consumer installment		11,547	28	111		11,686
Total	$	365,600	11,147	6,812	2,804	$ 386,363
December 31, 2013:						
Commercial and industrial	$	53,060	4,183	482	55	$ 57,780
Construction and land development		33,616	180	1,101	1,582	36,479
Commercial real estate:						
Owner occupied		53,430	770	875	1,027	56,102
Other		117,490	91	808	429	118,818
Total commercial real estate		170,920	861	1,683	1,456	174,920
Residential real estate:						
Consumer mortgage		50,392	1,137	5,476	866	57,871
Investment property		40,517	1,310	1,706	302	43,835
Total residential real estate		90,909	2,447	7,182	1,168	101,706
Consumer installment		12,713	34	146		12,893
Total	$	361,218	7,705	10,594	4,261	$ 383,778

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Impaired loans

The following tables present details related to the Company s impaired loans. Loans which have been fully charged-off do not appear in the following table. The related allowance generally represents the following components which correspond to impaired loans:

Individually evaluated impaired loans equal to or greater than $500,000 secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate loans).

Individually evaluated impaired loans equal to or greater than $250,000 not secured by real estate (nonaccrual commercial and industrial and consumer installment loans).

The following tables set forth certain information regarding the Company s impaired loans that were individually evaluated for impairment at June 30, 2014 and December 31, 2013.

	June 30, 2014			
(In thousands)	**Unpaid principal balance (1)**	**Charge-offs and payments applied (2)**	**Recorded investment (3)**	**Related allowance**
With no allowance recorded:				
Commercial and industrial	$ 95		95	
Construction and land development	2,960	(1,997)	963	
Commercial real estate:				
Owner occupied	337	(61)	276	
Other	300	(90)	210	
Total commercial real estate	637	(151)	486	
Residential real estate:				
Consumer mortgages	941	(224)	717	
Investment property	206	(42)	164	
Total residential real estate	1,147	(266)	881	
Total	$ 4,839	(2,414)	2,425	
With allowance recorded:				
Commercial real estate:				
Owner occupied	861		861	117
Other	592		592	52
Total commercial real estate	1,453		1,453	169
Total	$ 1,453		1,453	$ 169
Total impaired loans	$ 6,292	(2,414)	3,878	$ 169

(1) Unpaid principal balance represents the contractual obligation due from the customer.
(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance subsequent to the loans being placed on nonaccrual status.
(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

	December 31, 2013	
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)