PLUMAS BANCORP
Form 10-Q
November 05, 2014
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED September 30, 2014

TRANSITION REPORT UNDER SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM __________ TO ___________

COMMISSION FILE NUMBER: 000-49883

PLUMAS BANCORP

(Exact Name of Registrant as Specified in Its Charter)

California	**75-2987096**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
35 S. Lindan Avenue, Quincy, California	**95971**
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code **(530) 283-7305**

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "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	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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of November 3, 2014.
4,795,139 shares

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PLUMAS BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share data)

	September 30, 2014	December 31, 2013
Assets		
Cash and cash equivalents	$ 62,219	$ 49,917
Investment securities available for sale	84,304	90,343
Loans, less allowance for loan losses of $5,251 at September 30, 2014 and $5,517 at December 31, 2013	359,171	334,374
Premises and equipment, net	11,796	12,519
Bank owned life insurance	11,762	11,504
Real estate and vehicles acquired through foreclosure	3,951	6,459
Accrued interest receivable and other assets	9,894	10,609
Total assets	$ 543,097	$ 515,725
Liabilities and Shareholders' Equity		
Deposits:		
Non-interest bearing	$ 181,875	$ 162,816
Interest bearing	290,339	286,623
Total deposits	472,214	449,439
Repurchase agreements	11,466	9,109
Note payable	1,000	3,000
Subordinated debenture	7,414	7,295
Accrued interest payable and other liabilities	6,005	5,979
Junior subordinated deferrable interest debentures	10,310	10,310
Total liabilities	508,409	485,132
Commitments and contingencies (Note 5)		
Shareholders' equity:		

Common stock, no par value; 22,500,000 shares authorized; issued and outstanding – 4,795,139 shares at September 30, 2014 and 4,787,739 at December 31, 2013	6,328	6,249
Retained earnings	28,901	25,507
Accumulated other comprehensive loss	(541)	(1,163)
Total shareholders’ equity	34,688	30,593
Total liabilities and shareholders’ equity	$ 543,097	$ 515,725

See notes to unaudited condensed consolidated financial statements.

PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
Interest Income:				
Interest and fees on loans	$4,898	$4,687	$14,265	$13,583
Interest on investment securities	368	301	1,122	826
Other	36	38	92	86
Total interest income	5,302	5,026	15,479	14,495
Interest Expense:				
Interest on deposits	126	151	390	459
Interest on note payable	34	-	98	-
Interest on subordinated debenture	191	191	568	351
Interest on junior subordinated deferrable interest debentures	79	76	228	235
Other	2	3	4	54
Total interest expense	432	421	1,288	1,099
Net interest income before provision for loan losses	4,870	4,605	14,191	13,396
Provision for Loan Losses	300	100	750	1,200
Net interest income after provision for loan losses	4,570	4,505	13,441	12,196
Non-Interest Income:				
Service charges	1,064	1,029	3,122	2,847
Gain on sale of loans	304	170	1,081	1,126
Gain on sale of investments	128	-	128	-
Other	399	332	1,145	956
Total non-interest income	1,895	1,531	5,476	4,929
Non-Interest Expenses:				
Salaries and employee benefits	2,287	2,244	7,049	6,545
Occupancy and equipment	699	695	2,235	2,118
Other	1,302	1,414	4,029	4,366
Total non-interest expenses	4,288	4,353	13,313	13,029
Income before provision for income taxes	2,177	1,683	5,604	4,096
Provision for Income Taxes	850	676	2,210	1,581
Net Income	1,327	1,007	3,394	2,515
Discount on Redemption of Preferred Stock	-	4	-	534
Preferred Stock Dividends and Discount Accretion	-	(49)	-	(330)
Net income available to common shareholders	$1,327	$962	$3,394	$2,719

Basic earnings per share	$0.28	$0.20	$0.71	$0.57
Diluted earnings per share	$0.27	$0.20	$0.68	$0.56

See notes to unaudited condensed consolidated financial statements.

PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$1,327	$1,007	$3,394	$2,515
Other comprehensive income (loss) :				
Change in net unrealized gains	(334)	110	1,188	(1,875)
Less: reclassification adjustments for net gains included in net income	(128)	-	(128)	-
Net unrealized holding gains (losses)	(462)	110	1,060	(1,875)
Income tax effect	191	(45)	(438)	774
Other comprehensive income (loss)	(271)	65	622	(1,101)
Total comprehensive income	$1,056	$1,072	$4,016	$1,414

See notes to unaudited condensed consolidated financial statements.

PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	For the Nine Months Ended September 30,	
	2014	**2013**
Cash Flows from Operating Activities:		
Net income	$3,394	$2,515
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	750	1,200
Change in deferred loan origination costs/fees, net	(545)	(568)
Depreciation and amortization	977	1,082
Stock-based compensation expense	57	29
Amortization of investment security premiums	369	330
Gain on sale of investments	(128)	-
Gain on sale of other vehicles	(34)	(6)
Gain on sale of OREO	(100)	(160)
Gain on sale of loans held for sale	(1,081)	(1,126)
Loans originated for sale	(15,371)	(11,737)
Proceeds from loan sales	16,574	17,026
Provision from change in OREO valuation	226	372
Earnings on bank-owned life insurance	(258)	(258)
Decrease in accrued interest receivable and other assets	62	1,813
Increase (decrease) in accrued interest payable and other liabilities	26	(46)
Net cash provided by operating activities	4,918	10,466
Cash Flows from Investing Activities:		
Proceeds from matured and called available-for-sale investment securities	16,044	13,000
Proceeds from principal repayments from available-for-sale government-sponsored mortgage-backed securities	7,163	6,493
Purchases of available-for-sale securities	(32,667)	(27,958)
Proceeds from sale of available-for-sale securities	16,325	-
Net increase in loans	(25,717)	(19,481)
Proceeds from sale of OREO	2,981	1,900
Proceeds from sale of other vehicles	202	122
Purchase of premises and equipment	(101)	(186)
Net cash used in investing activities	(15,770)	(26,110)

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PLUMAS BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

(Continued)

	For the Nine Months Ended September 30, 2014	2013
Cash Flows from Financing Activities:		
Net increase in demand, interest bearing and savings deposits	$28,319	$56,289
Net decrease in time deposits	(5,544)	(6,497)
Issuance of subordinated debenture, net of discount	-	7,182
Issuance of common stock warrant	-	318
Repurchase of common stock warrant	-	(234)
Redemption of preferred stock	-	(8,282)
Payment of dividends on preferred stock	-	(1,979)
Payment on note payable	(2,000)	-
Net increase (decrease) in securities sold under agreements to repurchase	2,357	(667)
Proceeds from exercise of stock options	22	19
Net cash provided by financing activities	23,154	46,149
Increase in cash and cash equivalents	12,302	30,505
Cash and Cash Equivalents at Beginning of Year	49,917	44,675
Cash and Cash Equivalents at End of Period	$62,219	$75,180
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for:		
Interest expense	$1,189	$2,069
Income taxes	1,326	30
Non-Cash Investing Activities:		
Real estate and vehicles acquired through foreclosure	$351	$3,562

See notes to unaudited condensed consolidated financial statements.

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PLUMAS BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. GENERAL

During 2002, Plumas Bancorp (the "Company") was incorporated as a bank holding company for the purpose of acquiring Plumas Bank (the "Bank") in a one bank holding company reorganization. This corporate structure gives the Company and the Bank greater flexibility in terms of operation, expansion and diversification. The Company formed Plumas Statutory Trust I ("Trust I") for the sole purpose of issuing trust preferred securities on September 26, 2002. The Company formed Plumas Statutory Trust II ("Trust II") for the sole purpose of issuing trust preferred securities on September 28, 2005.

The Bank operates eleven branches in California, including branches in Alturas, Chester, Fall River Mills, Greenville, Kings Beach, Portola, Quincy, Redding, Susanville, Tahoe City, and Truckee. The Bank’s administrative headquarters is in Quincy, California. In addition, the Bank operates a loan administrative office in Reno, Nevada, lending offices specializing in government-guaranteed lending in Auburn, California and Beaverton, Oregon and a commercial/agricultural lending office in Chico, California. The Bank's primary source of revenue is generated from providing loans to customers who are predominately small and middle market businesses and individuals residing in the surrounding areas.

2. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The condensed consolidated financial statements include the accounts of the Company and the accounts of its wholly-owned subsidiary, Plumas Bank. Plumas Statutory Trust I and Plumas Statutory Trust II are not consolidated into the Company’s consolidated financial statements and, accordingly, are accounted for under the equity method. In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the Company’s financial position at September 30, 2014 and the results of its operations and its cash flows for the three-month and nine month periods ended September 30, 2014 and 2013. Our condensed consolidated balance sheet at December 31, 2013 is derived from audited financial statements. Certain reclassifications have been made to prior period’s balances to conform to classifications used in 2014.

The unaudited condensed consolidated financial statements of the Company have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2013 Annual Report to Shareholders on Form 10-K. The results of operations for the three-month and nine-month periods ended September 30, 2014 may not necessarily be indicative of future operating results. In preparing such financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the periods reported. Actual results could differ significantly from those estimates.

Management has determined that because all of the commercial banking products and services offered by the Company are available in each branch of the Bank, all branches are located within the same economic environment and management does not allocate resources based on the performance of different lending or transaction activities, it is appropriate to aggregate the Bank branches and report them as a single operating segment. No single customer accounts for more than 10% of the revenues of the Company or the Bank.

3. INVESTMENT SECURITIES AVAILABLE FOR SALE

The amortized cost and estimated fair value of investment securities at September 30, 2014 and December 31, 2013 consisted of the following, in thousands:

	September 30, 2014			
Available-for-Sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government-sponsored agencies	$ 7,003	$ 2	$ (38)	$ 6,967
U.S. Government-sponsored agencies collateralized by mortgage obligations- residential	67,743	25	(1,068)	66,700
Obligations of states and political subdivisions	9,976	169	(8)	10,137
Corporate debt securities	502	-	(2)	500
	$ 85,224	$ 196	$ (1,116)	$ 84,304

Net unrealized loss on available-for-sale investment securities totaling $920,000 were recorded, net of $379,000 in tax benefits, as accumulated other comprehensive income within shareholders' equity at September 30, 2014. During the nine months ended September 30, 2014 the Company sold fourteen available-for-sale securities for $16,324,000, recording a $128,000 gain on sale.

	December 31, 2013			
Available-for-Sale:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government-sponsored agencies	$ 27,132	$ 40	$ (75)	$ 27,097
U.S. Government-sponsored agencies collateralized by mortgage obligations- residential	63,807	22	(1,954)	61,875
Obligations of states and political subdivisions	1,384	4	(17)	1,371
	$ 92,323	$ 66	$ (2,046)	$ 90,343

Net unrealized loss on available-for-sale investment securities totaling $1,980,000 were recorded, net of $817,000 in tax benefits, as accumulated other comprehensive income within shareholders' equity at December 31, 2013. No securities were sold during the year ended December 31, 2013.

There were no transfers of available-for-sale investment securities during the nine months ended September 30, 2014 and twelve months ended December 31, 2013. There were no securities classified as held-to-maturity at September 30, 2014 or December 31, 2013.

Investment securities with unrealized losses at September 30, 2014 and December 31, 2013 are summarized and classified according to the duration of the loss period as follows, in thousands:

	Less than 12 Months		12 Months or More		Total	
September 30, 2014	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
U.S. Government- sponsored agencies	$3,003	$ 13	$2,973	$ 25	$5,976	$ 38
U.S. Government agencies collateralized by mortgage obligations-residential	21,788	87	36,862	981	58,650	1,068
Obligations of states and political subdivisions	1,048	8	-	-	1,048	8
Corporate debt securities	500	2	-	-	500	2
	$26,339	$ 110	$39,835	$ 1,006	$66,174	$ 1,116
December 31, 2013						
Debt securities:						
U.S. Government- sponsored agencies	$5,930	$ 75	$-	$ -	$5,930	$ 75
U.S. Government agencies collateralized by mortgage obligations-residential	53,603	1,700	4,317	254	57,920	1,954
Obligations of states and political subdivisions	928	17	-	-	928	17
	$60,461	$ 1,792	$4,317	$ 254	$64,778	$ 2,046

At September 30, 2014, the Company held 107 securities of which 61 were in a loss position. Of the securities in a loss position, 27 were in a loss position for less than twelve months. Of the 61 securities 6 are U.S. Government-sponsored agencies, 49 are U.S. Government-sponsored agencies collateralized by residential mortgage obligations 5 were obligations of states and political subdivisions and 1 is a corporate debt security. The unrealized losses relate principally to market rate conditions. All of the securities continue to pay as scheduled. When analyzing an issuer's financial condition, management considers the length of time and extent to which the market value has been less than cost; the historical and implied volatility of the security; the financial condition of the issuer of the security; and the Company's intent and ability to hold the security to recovery. As of September 30, 2014, management does not have the intent to sell these securities nor does it believe it is more likely than not that it will be required to sell these securities before the recovery of its amortized cost basis. Based on the Company's evaluation of the above and other relevant factors, the Company does not believe the securities that are in an unrealized loss position as of September 30, 2014 are other than temporarily impaired.

The amortized cost and estimated fair value of investment securities at September 30, 2014 by contractual maturity are shown below, in thousands.

	Amortized Cost	Estimated Fair

		Value
Within one year	$ -	$ -
After one year through five years	7,505	7,467
After five years through ten years	7,152	7,268
After ten years	2,824	2,869
Investment securities not due at a single maturity date:		
Government-sponsored mortgage-backed securities	67,743	66,700
	$ 85,224	$ 84,304

Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties. Investment securities with amortized costs totaling $57,804,000 and $54,373,000 and estimated fair values totaling $57,085,000 and $53,493,000 September 30, 2014 and December 31, 2013, respectively, were pledged to secure deposits and repurchase agreements.

4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES

Outstanding loans are summarized below, in thousands:

	September 30, 2014	December 31, 2013
Commercial	$33,583	$32,612
Agricultural	34,624	30,647
Real estate - residential	28,321	31,322
Real estate – commercial	162,184	155,942
Real estate – construction and land development	21,356	17,793
Equity lines of credit	37,665	35,800
Auto	40,754	30,305
Other	4,244	4,130
	362,731	338,551
Deferred loan costs, net	1,691	1,340
Allowance for loan losses	(5,251)	(5,517)
	$359,171	$334,374

Changes in the allowance for loan losses, in thousands, were as follows:

	September 30, 2014	December 31, 2013
Balance, beginning of year	$ 5,517	$ 5,686
Provision charged to operations	750	1,400
Losses charged to allowance	(1,702)	(1,915)
Recoveries	686	346
Balance, end of year	$ 5,251	$ 5,517

The recorded investment in impaired loans totaled $7,919,000 and $9,815,000 at September 30, 2014 and December 31, 2013, respectively. The Company had specific allowances for loan losses of $676,000 on impaired loans of $2,008,000 at September 30, 2014 as compared to specific allowances for loan losses of $629,000 on impaired loans of $2,322,000 at December 31, 2013. The balance of impaired loans in which no specific reserves were required totaled $5,911,000 and $7,493,000 at September 30, 2014 and December 31, 2013, respectively. The average recorded investment in impaired loans for the nine months ended September 30, 2014 and September 30, 2013 was $7,949,000 and $10,340,000, respectively. The Company recognized $94,000 and $229,000 in interest income on a cash basis for impaired loans during the nine months ended September 30, 2014 and 2013, respectively. During the three months ended September 30, 2014 and 2013 the Company recognized $30,000 and $19,000 in interest income on a cash basis for impaired loans, respectively.

Included in impaired loans are troubled debt restructurings. A troubled debt restructuring is a formal restructure of a loan where the Company for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower. The concessions may be granted in various forms to include one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's internal underwriting policy.

The carrying value of troubled debt restructurings at September 30, 2014 and December 31, 2013 was $6,001,000 and $7,616,000, respectively. The Company has allocated $384,000 and $284,000 of specific reserves on loans to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2014 and December 31, 2013, respectively. The Company has not committed to lend additional amounts on loans classified as troubled debt restructurings at September 30, 2014 and December 31, 2013.

During the three and nine month periods ended September 30, 2014, one loan was modified as a troubled debt restructuring.

The following table presents information related to the one loan modified as a troubled debt restructuring during the three and nine months ending September 30, 2014, dollars in thousands:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Recorded Investment
Troubled Debt Restructurings:			
Auto	1	$ 10	$ 10
Total	1	$ 10	$ 10

The troubled debt restructuring described above resulted in no allowance for loan losses or charge-offs during the nine months ending September 30, 2014.

During the three and nine month periods ended September 30, 2013, the terms of certain loans were modified as troubled debt restructurings. Modifications involving a reduction of the stated interest rate of the loan was for periods ranging from 1 month to 10 years and those with decreases in rates ranged from 0% to 1.5%.

The following table presents loans by class modified as troubled debt restructurings that occurred during the nine months ending September 30, 2013, dollars in thousands:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Recorded Investment
Troubled Debt Restructurings:			
Auto	1	$ 8	$ 7
Other	1	9	9
Total	2	$ 17	$ 16

The troubled debt restructurings described above resulted in no allowance for loan losses or charge-offs during the nine months ending September 30, 2013.

The following table presents loans by class modified as troubled debt restructurings that occurred during the three months ending September 30, 2013, dollars in thousands:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Recorded Investment
Troubled Debt Restructurings:			
Other	1	$ 9	$ 9
Total	1	$ 9	$ 9

The troubled debt restructuring described above resulted in no allowance for loan losses or charge-offs during the nine months ending September 30, 2013.

There were no troubled debt restructurings for which there was a payment default within twelve months following the modification during the nine months ended September 30, 2014.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the nine months ended September 30, 2013, dollars in thousands:

	Number of Loans	Recorded Investment
Troubled Debt Restructurings:		
Real estate – construction	1	$ 1,152
Total	1	$ 1,152

The troubled debt restructuring described above increased the allowance for loan losses by $154,000 and resulted in no charge offs during the nine months ended September 30, 2013. There were no loans for which there was a payment default within twelve months following the modification during the three months ended September 30, 2013.

The terms of certain other loans were modified during the nine months ending September 30, 2014 and year ending December 31, 2013 that did not meet the definition of a troubled debt restructuring. These loans have a total recorded investment as of September 30, 2014 and December 31, 2013 of $22 million and $14 million, respectively.

These loans which were modified during the nine months ended September 30, 2014 and year ended December 31, 2013 did not meet the definition of a troubled debt restructuring as the modification was a delay in a payment ranging from 30 days to 3 months that was considered to be insignificant or the borrower was not considered to be experiencing financial difficulties.

At September 30, 2014 and December 31, 2013, nonaccrual loans totaled $5,943,000 and $5,519,000, respectively. Interest foregone on nonaccrual loans totaled $286,000 and $290,000 for the nine months ended September 30, 2014 and 2013, respectively. Interest foregone on nonaccrual loans totaled $82,000 and $120,000 for the three months ended September 30, 2014 and 2013, respectively. Loans past due 90 days or more and on accrual status totaled $2,000 and $17,000 at September 30, 2014 and December 31, 2013, respectively.

Salaries and employee benefits totaling $1,081,000 and $993,000 have been deferred as loan origination costs during the nine months ended September 30, 2014 and 2013, respectively. Salaries and employee benefits totaling $406,000 and $321,000 have been deferred as loan origination costs during the three months ended September 30, 2014 and 2013, respectively.

The Company assigns a risk rating to all loans, with the exception of automobile and other loans and periodically, but not less than annually, performs detailed reviews of all such loans over $100,000 to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Company and the Company’s regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan.

The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Watch – A Watch loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Company’s credit position at some future date. Watch loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss – Loans classified as loss are considered uncollectible and charged off immediately.

The following table shows the loan portfolio allocated by management's internal risk ratings at the dates indicated, in thousands:

September 30, 2014

Commercial Credit Exposure

Credit Risk Profile by Internally Assigned Grade

Grade:	Commercial	Agricultural	Real Estate-Residential	Real Estate-Commercial	Real Estate-Construction	Equity LOC	Total
Pass	$32,268	$ 33,844	$ 27,032	$ 155,162	$ 20,085	$36,829	$305,220
Watch	922	381	277	3,550	-	146	5,276
Substandard	393	399	1,013	3,471	1,271	690	7,237
Doubtful	-	-	-	-	-	-	-
Total	$33,583	$ 34,624	$ 28,322	$ 162,183	$ 21,356	$37,665	$317,733

December 31, 2013

Commercial Credit Exposure

Credit Risk Profile by Internally Assigned Grade

Grade:	Commercial	Agricultural	Real Estate-Residential	Real Estate-Commercial	Real Estate-Construction	Equity LOC	Total
Pass	$30,477	$ 30,213	$ 30,007	$ 147,605	$ 17,733	$34,742	$290,777
Watch	1,420	345	346	3,484	-	157	5,752
Substandard	665	89	969	4,853	60	890	7,526
Doubtful	50	-	-	-	-	11	61
Total	$32,612	$ 30,647	$ 31,322	$ 155,942	$ 17,793	$35,800	$304,116

Consumer Credit Exposure Credit Risk Profile Based on Payment Activity September 30, 2014			Consumer Credit Exposure Credit Risk Profile Based on Payment Activity December 31, 2013		
Auto	Other	Total	Auto	Other	Total

Grade:						
Performing	$40,663	$4,230	$44,893	$30,228	$4,113	$34,341
Non-performing	91	14	105	77	17	94
Total	$40,754	$4,244	$44,998	$30,305	$4,130	$34,435

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The following tables show the allocation of the allowance for loan losses at the dates indicated, in thousands:

	Commercial	Agricultural	Real Estate-Residential	Real Estate-Commercial	Real Estate-Construction	Equity LOC	Auto	Other	Total
Nine months ended September 30, 2014:									
Allowance for Loan Losses									
Beginning balance	$ 785	$ 164	$ 638	$ 1,774	$ 944	$ 613	$ 449	$ 150	$ 5,517
Charge-offs	(191)	-	(145)	(887)	-	(142)	(253)	(84)	(1,702)
Recoveries	50	-	29	5	491	15	33	63	686
Provision	(33)	54	(114)	636	(238)	137	311	(3)	750
Ending balance	$ 611	$ 218	$ 408	$ 1,528	$ 1,197	$ 623	$ 540	$ 126	$ 5,251
Three months ended September 30, 2014:									
Allowance for Loan Losses									
Beginning balance	$ 703	$ 211	$ 423	$ 1,686	$ 1,140	$ 603	$ 466	$ 126	$ 5,358
Charge-offs	(98)	-	-	(208)	-	-	(148)	(27)	(481)
Recoveries	23	-	2	4	-	2	12	31	74
Provision	(17)	7	(17)	46	57	18	210	(4)	300
Ending balance	$ 611	$ 218	$ 408	$ 1,528	$ 1,197	$ 623	$ 540	$ 126	$ 5,251
Nine months ended September 30, 2013:									
Allowance for Loan Losses									
Beginning balance	$ 855	$ 159	$ 894	$ 1,656	$ 950	$ 736	$ 289	$ 147	$ 5,686
Charge-offs	(389)	-	(244)	(133)	(735)	(21)	(82)	(125)	(1,729)
Recoveries	62	-	1	13	-	1	45	26	148
Provision	203	(3)	(26)	45	667	91	125	98	1,200
Ending balance	$ 731	$ 156	$ 625	$ 1,581	$ 882	$ 807	$ 377	$ 146	$ 5,305
Three months ended									

September 30, 2013:									
Allowance for Loan Losses									
Beginning balance	$ 720	$ 183	$ 604	$ 1,655	$ 886	$ 704	$ 351	$ 160	$ 5,263
Charge-offs	(36)	-	(23)	(1)	-	-	(33)	(27)	(120)
Recoveries	34	-	1	2	-	-	17	8	62
Provision	13	(27)	43	(75)	(4)	103	42	5	100
Ending balance	$ 731	$ 156	$ 625	$ 1,581	$ 882	$ 807	$ 377	$ 146	$ 5,305

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	Commercial	Agricultural	Real Estate - Residential	Real Estate -Commercial	Real Estate -Construction	Equity LOC	Auto	Other	Total
<u>September 30, 2014:</u>									
<u>Allowance for Loan Losses</u>									
Ending balance: individually evaluated for impairment	$ 22	$ -	$ 99	$ 50	$ 342	$ 163	$ -	$ -	$ 676
Ending balance: collectively evaluated for impairment	$ 589	$ 218	$ 309	$ 1,478	$ 855	$ 460	$ 540	$ 126	$ 4,575
<u>Loans</u>									
Ending balance	$ 33,583	$ 34,624	$ 28,321	$ 162,184	$ 21,356	$ 37,665	$ 40,754	$ 4,244	$ 362,731
Ending balance: individually evaluated for impairment	$ 133	$ 605	$ 2,539	$ 2,474	$ 1,413	$ 652	$ 91	$ 12	$ 7,919
Ending balance: collectively evaluated for impairment	$ 33,450	$ 34,019	$ 25,782	$ 159,710	$ 19,943	$ 37,013	$ 40,663	$ 4,232	$ 354,812
<u>December 31, 2013:</u>									
<u>Allowance for Loan Losses</u>									
Ending balance: individually evaluated for impairment	$ 79	$ -	$ 200	$ 232	$ 13	$ 105	$ -	$ -	$ 629
Ending balance: collectively evaluated for impairment	$ 706	$ 164	$ 438	$ 1,542	$ 931	$ 508	$ 449	$ 150	$ 4,888
<u>Loans</u>									
Ending balance	$ 32,612	$ 30,647	$ 31,322	$ 155,942	$ 17,793	$ 35,800	$ 30,305	$ 4,130	$ 338,551
Ending balance: individually evaluated for impairment	$ 1,324	$ 267	$ 2,475	$ 3,074	$ 1,737	$ 861	$ 77	$ -	$ 9,815
Ending balance: collectively	$ 31,288	$ 30,380	$ 28,847	$ 152,868	$ 16,056	$ 34,939	$ 30,228	$ 4,130	$ 328,736

evaluated for
impairment

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The following table shows an aging analysis of the loan portfolio by the time past due, in thousands:

As of September 30, 2014	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total
Commercial:						
Commercial	$93	$ -	$ 109	$202	$33,381	$33,583
Agricultural	-	-	340	340	34,284	34,624
Real estate – construction	-	-	1,271	1,271	20,085	21,356
Real estate	1,264	-	2,474	3,738	158,445	162,183
Residential:						
Real estate	158	-	994	1,152	27,170	28,322
Equity LOC	352	-	652	1,004	36,661	37,665
Consumer:						
Auto	497	-	91	588	40,166	40,754
Other	39	2	12	53	4,191	4,244
Total	$2,403	$ 2	$ 5,943	$8,348	$354,383	$362,731

As of December 31, 2013	30-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total
Commercial:						
Commercial	$129	$ -	$ 1,295	$1,424	$31,188	$32,612
Agricultural	-	-	-	-	30,647	30,647
Real estate – construction	25	-	18	43	17,750	17,793
Real estate	304	-	2,369	2,673	153,269	155,942
Residential:						
Real estate	695	-	899	1,594	29,728	31,322
Equity LOC	72	-	861	933	34,867	35,800
Consumer:						
Auto	244	-	77	321	29,984	30,305
Other	63	17	-	80	4,050	4,130
Total	$1,532	$ 17	$ 5,519	$7,068	$331,483	$338,551

The following tables show information related to impaired loans at the dates indicated, in thousands:

As of September 30, 2014:	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 92	$ 92		$ 70	$ 1
Agricultural	605	605		285	15
Real estate – construction	504	504		481	7
Real estate – commercial	2,220	2,867		2,379	-
Real estate – residential	2,084	2,095		2,035	63
Equity Lines of Credit	303	303		288	-
Auto	91	91		45	-
Other	12	12		-	-
With an allowance recorded:					
Commercial	$ 41	$ 41	$ 22	$ 42	$ -
Agricultural	-	-	-	-	-
Real estate – construction	909	909	342	923	-
Real estate – commercial	254	254	50	589	-
Real estate – residential	455	461	99	460	8
Equity Lines of Credit	349	349	163	352	-
Auto	-	-	-	-	-
Other	-	-	-	-	-
Total:					
Commercial	$ 133	$ 133	$ 22	$ 112	$ 1
Agricultural	605	605	-	285	15
Real estate – construction	1,413	1,413	342	1,404	7
Real estate – commercial	2,474	3,121	50	2,968	-
Real estate – residential	2,539	2,556	99	2,495	71
Equity Lines of Credit	652	652	163	640	-
Auto	91	91	-	45	-
Other	12	12	-	-	-
Total	$ 7,919	$ 8,583	$ 676	$ 7,949	$ 94

As of December 31, 2013:	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 1,224	$ 1,493		$ 1,239	$ 3
Agricultural	267	267		267	20
Real estate – construction	1,325	1,325		1,384	79
Real estate – commercial	2,237	2,675		2,489	53

Real estate – residential	2,024	2,035		2,057	89
Equity Lines of Credit	339	339		294	9
Auto	77	77		20	3
Other	-	-		-	-
With an allowance recorded:					
Commercial	$ 100	$ 100	$ 79	$ 58	$ -
Agricultural	-	-	-	-	-
Real estate – construction	412	412	13	417	25
Real estate – commercial	837	837	232	994	-
Real estate – residential	451	451	200	452	10
Equity Lines of Credit	522	522	105	511	7
Auto	-	-	-	-	-
Other	-	-	-	-	-
Total:					
Commercial	$ 1,324	$ 1,593	$ 79	$ 1,297	$ 3
Agricultural	267	267	-	267	20
Real estate – construction	1,737	1,737	13	1,801	104
Real estate – commercial	3,074	3,512	232	3,483	53
Real estate – residential	2,475	2,486	200	2,509	99
Equity Lines of Credit	861	861	105	805	16
Auto	77	77	-	20	3
Other	-	-	-	-	-
Total	$ 9,815	$ 10,533	$ 629	$ 10,182	$ 298

5. COMMITMENTS AND CONTINGENCIES

The Company is party to claims and legal proceedings arising in the ordinary course of business. In the opinion of the Company's management, the amount of ultimate liability with respect to such proceedings will not have a material adverse effect on the financial condition or result of operations of the Company taken as a whole.

In the normal course of business, there are various outstanding commitments to extend credit, which are not reflected in the financial statements, including loan commitments of $89,968,000 and $84,229,000 and stand-by letters of credit of $0 and $60,000 at September 30, 2014 and December 31, 2013, respectively.

Of the loan commitments outstanding at September 30, 2014, $14,627,000 are real estate construction loan commitments that are expected to fund within the next twelve months. The remaining commitments primarily relate to revolving lines of credit or other commercial loans, and many of these are expected to expire without being drawn upon. Therefore, the total commitments do not necessarily represent future cash requirements. Each loan commitment and the amount and type of collateral obtained, if any, are evaluated on an individual basis. Collateral held varies, but may include real property, bank deposits, debt or equity securities or business assets.

Stand-by letters of credit are conditional commitments written to guarantee the performance of a customer to a third party. These guarantees are primarily related to the purchases of inventory by commercial customers and are typically short-term in nature. Credit risk is similar to that involved in extending loan commitments to customers and accordingly, evaluation and collateral requirements similar to those for loan commitments are used. The deferred liability related to the Company's stand-by letters of credit was not significant at September 30, 2014 and December 31, 2013.

6. EARNINGS PER SHARE

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which shares in the earnings of the Company. The treasury stock method has been applied to determine the dilutive effect of stock options in computing diluted earnings per share.

	For the Three Months	For the Nine Months

(In thousands, except per share data)	Ended September 30, 2014	2013	Ended September 30, 2014	2013
Net Income:				
Net income	$1,327	$1,007	$3,394	$2,515
Discount on redemption of preferred stock	-	4	-	534
Dividends and discount accretion on preferred shares	-	(49)	-	(330)
Net income available to common shareholders	$1,327	$962	$3,394	$2,719
Earnings Per Share:				
Basic earnings per share	$0.28	$0.20	$0.71	$0.57
Diluted earnings per share	$0.27	$0.20	$0.68	$0.56
Weighted Average Number of Shares Outstanding:				
Basic shares	4,795	4,782	4,792	4,779
Diluted shares	4,995	4,922	4,970	4,868

Shares of common stock issuable under stock options and warrants for which the exercise prices were greater than the average market prices were not included in the computation of diluted earnings per share due to their antidilutive effect. Stock options and warrants not included in the computation of diluted earnings per share, due to shares not being in-the-money and having an antidilutive effect, were approximately 238,000 and 200,000 for the three month periods ended September 30, 2014 and 2013, respectively. Stock options and warrants not included in the computation of diluted earnings per share, due to shares not being in-the-money and having an antidilutive effect, were approximately 267,000 and 280,000 for the nine month periods ended September 30, 2014 and 2013, respectively.

7. STOCK-BASED COMPENSATION

Stock Options

In 2001, the Company established a Stock Option Plan (the "2001 Plan") for which 339,209 shares of common stock remain reserved for issuance to employees and directors and no shares are available for future grants as of September 30, 2014.

A summary of the activity within the 2001 Plan follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Intrinsic Value
Options outstanding at January 1, 2014	365,059	$ 8.53		
Options cancelled	(18,450)	12.77		
Options exercised	(7,400)	2.95		
Options outstanding at September 30, 2014	339,209	$ 8.42	2.7	$871,956
Options exercisable at September 30, 2014	290,016	$ 9.35	2.4	$637,272
Expected to vest after September 30, 2014	41,918	$ 2.95	4.5	$199,951

Compensation cost related to stock options recognized in operating results under the 2001 Plan was $34,000 and $29,000 for the nine months ended September 30, 2014 and 2013, respectively. The associated future income tax benefit recognized was $1,000 for the nine months ended September 30, 2014 and 2013. Compensation cost related to stock options recognized in operating results was $10,000 and $10,000 for the quarters ended September 30, 2014 and 2013. There was no associated future income tax benefit recognized for the quarters ended September 30, 2014 and 2013.

At September 30, 2014, there was $20,000 of total unrecognized compensation cost related to non-vested stock option awards which is expected to be recognized over a weighted-average period of six months.

The total fair value of options vested during the nine months ended September 30, 2014 was $49,000. The total intrinsic value of options exercised during the nine months ended September 30, 2014 was $30,000.

Cash received for options exercised during the nine months ended September 30, 2014 was $22,000. The tax benefit realized for the tax deductions from option exercise totaled $8,000 and $0, respectively, for the nine months ended September 30, 2014 and 2013.

In May 2013, the Company established the 2013 Stock Option Plan (the “2013 Plan”) for which 500,000 shares of common stock are reserved and 389,600 shares are available for future grants as of September 30, 2014. The Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid in full at the time the option is exercised. Payment in full for the option price must be made in cash, with Company common stock previously acquired by the optionee and held by the optionee for a period of at least six months, in options of the Optionee that are fully vested and exercisable or in any combination of the foregoing. The options expire on dates determined by the Board of Directors, but not later than ten years from the date of grant.

The fair value of each option is estimated on the date of grant using the following assumptions in 2014.

	Nine Months Ended September 30, 2014
Expected life of stock options (years)	5.2
Interest rate—stock options	1.64%
Volatility—stock options	63.8%
Dividend yields	2.0%
Weighted-average fair value of options granted during the period	$3.02

A summary of the activity within the 2013 Plan follows:

	Shares	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term in Years**	**Intrinsic Value**
Options outstanding at January 1, 2014	-	$ -		
Options granted	110,400	6.32		
Options outstanding at September 30, 2014	110,400	$ 6.32	7.6	$154,560
Options exercisable at September 30, 2014	-	N/A	N/A	N/A
Expected to vest after September 30, 2014	94,061	$ 6.32	7.6	$131,685

Compensation cost related to stock options recognized in operating results under the 2013 Plan was $14,000 for the three months ended September 30, 2014 and $23,000 for the nine months ended September 30, 2014. There was no compensation cost recorded during 2013. The associated future income tax benefit recognized was $1,000 and $2,000 for the three months and nine months ended September 30, 2014, respectively and $0 for 2013. As of September 30, 2014, there was $200,000 of total unrecognized compensation cost related to non-vested, share-based compensation arrangements granted under the 2013 Plan. That cost is expected to be recognized over a weighted average period of 3.6 years.

8. INCOME TAXES

The Company files its income taxes on a consolidated basis with its subsidiary. Income tax expense is the total of current year income tax due or refundable and the change in deferred tax assets and liabilities.

Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax bases. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. A valuation allowance is recognized if, based on the weight of available evidence management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the consolidated income statement. There have been no significant changes to unrecognized tax benefits or accrued interest and penalties for the three or nine months ended September 30, 2014.

9. FAIR VALUE MEASUREMENT

The Company measures fair value under the fair value hierarchy described below.

Level 1: Quoted prices for identical instruments traded in active exchange markets.

Level 2: Quoted prices (unadjusted) for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3: Model based techniques that use one significant assumption not observable in the market. These unobservable assumptions reflect the Company’s estimates of assumptions that market participants would use on pricing the asset or liability. Valuation techniques include management judgment and estimation which may be significant.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company’s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

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Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at September 30, 2014 and December 31, 2013 are as follows, in thousands:

	Carrying Value	Fair Value Measurements at September 30, 2014 Using:			
		Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and cash equivalents	$62,219	$62,219			$62,219
Investment securities	84,304		$84,304		84,304
Loans, net	359,171			$361,213	361,213
FHLB stock	2,380				N/A
Accrued interest receivable	1,586		225	1,361	1,586
Financial liabilities:					
Deposits	472,214	415,076	57,163		472,239
Repurchase agreements	11,466		11,466		11,466
Note payable	1,000			1,000	1,000
Subordinated debenture	7,414			7,311	7,311
Junior subordinated deferrable interest debentures	10,310			6,853	6,853
Accrued interest payable	78	6	43	29	78

	Carrying Value	Fair Value Measurements at December 31, 2013 Using:			
		Level 1	Level 2	Level 3	Total Fair Value
Financial assets:					
Cash and cash equivalents	$49,917	$49,917			$49,917
Investment securities	90,343				