AUBURN NATIONAL BANCORPORATION, INC
Form 10-Q
November 01, 2013

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 September 30, 2013

[ ] 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 October 31, 2013
Common Stock, $0.01 par value per share	3,643,118 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)	**September 30, 2013**	**December 31, 2012**
Assets:		
Cash and due from banks	$ 14,088	$ 18,762
Federal funds sold	36,955	42,682
Interest bearing bank deposits	11,211	505
Cash and cash equivalents	62,254	61,949
Securities available-for-sale	259,467	259,475
Loans held for sale	2,367	2,887
Loans, net of unearned income	380,705	398,193
Allowance for loan losses	(5,946)	(6,723)
Loans, net	374,759	391,470
Premises and equipment, net	10,729	10,528
Bank-owned life insurance	17,365	17,076
Other real estate owned	4,585	4,919
Other assets	13,076	11,529
Total assets	$ 744,602	$ 759,833
Liabilities:		
Deposits:		
Noninterest-bearing	$ 118,965	$ 118,014
Interest-bearing	531,456	518,803
Total deposits	650,421	636,817
Federal funds purchased and securities sold under agreements to repurchase	2,743	2,689
Long-term debt	22,217	47,217
Accrued expenses and other liabilities	3,414	2,961
Total liabilities	678,795	689,684
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	3,758	3,756

Retained earnings		70,915		67,821
Accumulated other comprehensive (loss) income, net		(2,264)		5,174
Less treasury stock, at cost 314,077 shares and 314,232 shares at September 30, 2013 and December 31, 2012, respectively		(6,641)		(6,641)
Total stockholders equity		65,807		70,149
Total liabilities and stockholders equity	$	744,602	$	759,833

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 September 30, 2013	Quarter ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Interest income:				
Loans, including fees	$ 5,104	$ 5,548	$ 15,656	$ 16,303
Securities	1,713	1,653	4,936	5,482
Federal funds sold and interest bearing bank deposits	39	11	99	32
Total interest income	6,856	7,212	20,691	21,817
Interest expense:				
Deposits	1,344	1,509	4,097	4,839
Short-term borrowings	3	4	10	13
Long-term debt	239	440	941	1,393
Total interest expense	1,586	1,953	5,048	6,245
Net interest income	5,270	5,259	15,643	15,572
Provision for loan losses		1,550	400	2,750
Net interest income after provision for loan losses	5,270	3,709	15,243	12,822
Noninterest income:				
Service charges on deposit accounts	224	268	707	838
Mortgage lending	750	1,038	2,397	2,492
Bank-owned life insurance	93	120	289	332
Gain on sale of affordable housing investments				3,268
Other	365	413	1,086	1,157
Securities gains, net:				
Realized gains, net		178	679	738
Total other-than-temporary impairments				(130)
Total securities gains, net		178	679	608
Total noninterest income	1,432	2,017	5,158	8,695
Noninterest expense:				
Salaries and benefits	2,139	2,209	6,503	6,557
Net occupancy and equipment	346	345	1,010	1,019
Professional fees	197	163	582	538
FDIC and other regulatory assessments	130	153	467	521
Other real estate owned, net	68	119	111	182
Prepayment penalties on long-term debt	541		2,012	3,720
Other	853	781	2,539	2,823
Total noninterest expense	4,274	3,770	13,224	15,360

Earnings before income taxes		2,428		1,956		7,177		6,157
Income tax expense		636		347		1,789		1,054
Net earnings	$	1,792	$	1,609	$	5,388	$	5,103
Net earnings per share:								
Basic and diluted	$	0.49	$	0.44	$	1.48	$	1.40
Weighted average shares outstanding:								
Basic and diluted		3,643,028		3,642,876		3,642,967		3,642,807

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 September 30, 2013	Quarter ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Net earnings	$ 1,792	$ 1,609	$ 5,388	$ 5,103
Other comprehensive (loss) income, net of tax:				
Unrealized net holding (loss) gain on securities	(433)	1,162	(7,010)	2,307
Reclassification adjustment for net gain on securities recognized in net earnings		(113)	(428)	(384)
Other comprehensive (loss) income	(433)	1,049	(7,438)	1,923
Comprehensive income (loss)	$ 1,359	$ 2,658	$ (2,050)	$ 7,026

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, 2011	3,957,135	$ 39	$ 3,753	$ 64,045	$ 4,222	$ (6,643)	$ 65,416
Net earnings				5,103			5,103
Other comprehensive income					1,923		1,923
Cash dividends paid ($0.615 per share)				(2,240)			(2,240)
Sale of treasury stock (165 shares)			3			1	4
Balance, September 30, 2012	3,957,135	$ 39	$ 3,756	$ 66,908	$ 6,145	$ (6,642)	$ 70,206
Balance, December 31, 2012	3,957,135	$ 39	$ 3,756	$ 67,821	$ 5,174	$ (6,641)	$ 70,149
Net earnings				5,388			5,388
Other comprehensive loss					(7,438)		(7,438)
Cash dividends paid ($0.63 per share)				(2,294)			(2,294)
Sale of treasury stock (155 shares)			2				2
Balance, September 30, 2013	3,957,135	$ 39	$ 3,758	$ 70,915	$ (2,264)	$ (6,641)	$ 65,807

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)	Nine months ended September 30, 2013	2012
Cash flows from operating activities:		
Net earnings	$ 5,388	$ 5,103
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	400	2,750
Depreciation and amortization	639	609
Premium amortization and discount accretion, net	1,620	2,351
Net gain on securities available for sale	(679)	(608)
Net gain on sale of loans held for sale	(1,693)	(2,488)
Net loss on other real estate owned	13	121
Loss on prepayment of long-term debt	2,012	3,720
Loans originated for sale	(80,169)	(111,476)
Proceeds from sale of loans	81,689	110,932
Increase in cash surrender value of bank owned life insurance	(289)	(332)
Gain on sale of affordable housing partnership investments		(3,268)
Net decrease in other assets	2,019	687
Net increase in accrued expenses and other liabilities	453	541
Net cash provided by operating activities	11,403	8,642
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	38,614	49,693
Proceeds from maturities of securities available-for-sale	48,588	93,377
Purchase of securities available-for-sale	(99,923)	(97,002)
Decrease (increase) in loans, net	14,033	(31,740)
Net purchases of premises and equipment	(516)	(1,128)
Decrease in FHLB stock	1,153	2,067
Proceeds from sale of affordable housing limited partnerships		8,499
Proceeds from sale of other real estate owned	2,599	3,493
Net cash provided by investing activities	4,548	27,259
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	951	9,741
Net increase in interest-bearing deposits	12,653	531
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	54	(258)
Repayments or retirement of long-term debt	(27,012)	(41,816)
Proceeds from sale of treasury stock	2	4
Dividends paid	(2,294)	(2,240)
Net cash used in financing activities	(15,646)	(34,038)
Net change in cash and cash equivalents	305	1,863
Cash and cash equivalents at beginning of period	61,949	55,428

Cash and cash equivalents at end of period	$ 62,254	$ 57,291
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 5,228	$ 6,570
Income taxes	258	818
Supplemental disclosure of non-cash transactions:		
Real estate acquired through foreclosure	2,278	641

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, 2012.

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.

Subsequent Events

The Company has evaluated the effects of events and transactions through the date of this filing that have occurred subsequent to September 30, 2013. The Company does not believe there were any material subsequent events during this period that would have required recognition or disclosure in the unaudited consolidated financial statements included in this report.

Accounting Developments

In the first quarter of 2013, the Company adopted new guidance related to the following Accounting Standards Updates (Updates or ASUs):

ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*;

ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*; and

ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income.*

In the third quarter of 2013, the Company adopted new guidance related to the following Update:

- ASU 2013-10, *Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes*.

Information about these pronouncements is described in more detail below.

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ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, expands the disclosure requirements for financial instruments and derivatives that may be offset in accordance with enforceable master netting agreements or similar arrangements. The disclosures are required regardless of whether the instruments have been offset (or netted) in the statement of financial position. Under ASU 2011-11, companies must describe the nature of offsetting arrangements and provide quantitative information about those agreements, including the gross and net amounts of financial instruments that are recognized in the statement of financial position. In January 2013, the FASB issued ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities,* which clarifies the scope of the offsetting disclosures and addresses any unintended consequences due to feedback from stakeholders that standard commercial provisions of many contracts would equate to a master netting arrangement. These changes were effective for the Company in the first quarter of 2013 with retrospective application. Adoption of this ASU did not have a significant impact on the financial statements of the Company.

ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income,* seeks to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this Update will require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. These changes were effective for the Company in the first quarter of 2013 with retrospective application. This Update did not affect our consolidated financial results as it amends only the presentation of comprehensive income. See Consolidated Statements of Comprehensive Income.

ASU 2013-10, *Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes,* permits the Fed Funds Effective Swap Rate (Overnight Index Swap Rate) to be used as a U.S. benchmark interest rate for hedge accounting purposes, in addition to LIBOR and U.S. Treasury. The ASU also removes the restriction on using different benchmark rates for similar hedges. These changes are effective for the Company in the third quarter of 2013 with prospective application for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. Adoption of this ASU did not have a significant impact on the financial statements of the Company.

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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 September 30, 2013 and 2012, 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 September 30,		Nine months ended September 30,	
(In thousands, except share and per share data)	**2013**	**2012**	**2013**	**2012**
Basic and diluted:				
Net earnings	$ 1,792	$ 1,609	$ 5,388	$ 5,103
Weighted average common shares outstanding	3,643,028	3,642,876	3,642,967	3,642,807
Earnings per share	$ 0.49	$ 0.44	$ 1.48	$ 1.40

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 September 30, 2013, 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 September 30, 2013.

(Dollars in thousands)	**Maximum Loss Exposure**	**Liability Recognized**	**Classification**
Type:			
Trust preferred issuances	N/A	$ 7,217	Long-term debt

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NOTE 4: SECURITIES

At September 30, 2013 and December 31, 2012, 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 September 30, 2013 and December 31, 2012, 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**
September 30, 2013								
Agency obligations (a)	$		23,744	22,079	45,823		3,253	$ 49,076
Agency RMBS (a)			3,679	142,311	145,990	1,196	3,179	147,973
State and political subdivisions		2,096	19,739	45,077	66,912	1,998	399	65,313
Trust preferred securities				742	742	164	115	693
Total available-for-sale	$	2,096	47,162	210,209	259,467	3,358	6,946	$ 263,055
December 31, 2012								
Agency obligations (a)	$		20,065	19,460	39,525	187	19	$ 39,357
Agency RMBS (a)			4,700	136,760	141,460	3,012	162	138,610
State and political subdivisions	111	1,830	21,006	54,891	77,838	5,222		72,616
Trust preferred securities				652	652	113	154	693
Total available-for-sale	$ 111	1,830	45,771	211,763	259,475	8,534	335	$ 251,276

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

Securities with aggregate fair values of $135.8 million and $134.0 million at September 30, 2013 and December 31, 2012, 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 $1.8 million and $3.0 million at September 30, 2013 and December 31, 2012, 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 September 30, 2013 and December 31, 2012, 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**
September 30, 2013:						

Agency obligations	$	45,822	3,253				$	45,822	3,253
Agency RMBS		95,325	3,179					95,325	3,179
State and political subdivisions		7,751	399					7,751	399
Trust preferred securities				385	115		$	385	115
Total	$	148,898	6,831	385	115		$	149,283	6,946
December 31, 2012:									
Agency obligations	$	9,966	19				$	9,966	19
Agency RMBS		25,207	162					25,207	162
Trust preferred securities				346	154			346	154
Total	$	35,173	181	346	154		$	35,519	335

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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 residential mortgage-backed securities (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.

Trust preferred securities

The unrealized losses associated with individual issuer trust preferred securities were primarily driven by wider credit spreads. Management evaluates the financial performance of individual community bank holding companies on a quarterly basis to determine if it is probable that such issuer can make all contractual principal and interest payments. Based upon its evaluation, the Company expects to recover the remaining amortized cost basis of these securities.

Cost-method investments

At September 30, 2013, cost-method investments with an aggregate cost of $1.8 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.

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The carrying values of the Company s investment securities could decline in the future if the financial condition of individual issuers of trust preferred securities, or the credit quality of other securities deteriorate 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 significant other-than-temporary impairment charges may occur in the future.

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 September 30, 2013**	**2012**	**Nine months ended September 30, 2013**	**2012**
Balance, beginning of period	$ 757	$ 1,257	$ 1,257	$ 3,276
Additions:				
Subsequent credit impairments				130
Reductions:				
Securities sold				2,149
Securities fully written down and deemed worthless			500	
Balance, end of period	$ 757	$ 1,257	$ 757	$ 1,257

Other-Than-Temporary Impairment

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

(Dollars in thousands)	**Quarter ended September 30, 2013**	**2012**	**Nine months ended September 30, 2013**	**2012**
Other-than-temporary impairment charges (included in earnings):				
Debt securities:				
Individual issuer trust preferred securities	$	$	$	$ 130
Total debt securities				130
Total other-than-temporary impairment charges	$	$	$	$ 130
Other-than-temporary impairment on debt securities:				
Recorded as part of gross realized losses:				
Credit-related	$	$	$	$ 130
Total other-than-temporary impairment on debt securities	$	$	$	$ 130

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 September 30,**		**Nine months ended September 30,**	
	2013	**2012**	**2013**	**2012**
Gross realized gains	$	$ 203	$ 685	$ 927
Gross realized losses		(25)	(6)	(189)
Other-than-temporary impairment charges				(130)
Realized gains, net	$	$ 178	$ 679	$ 608

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NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)	September 30, 2013	December 31, 2012
Commercial and industrial	$ 58,766	$ 59,334
Construction and land development	37,062	37,631
Commercial real estate:		
Owner occupied	57,082	64,368
Other	113,438	119,243
Total commercial real estate	170,520	183,611
Residential real estate:		
Consumer mortgage	57,032	58,087
Investment property	45,533	47,544
Total residential real estate	102,565	105,631
Consumer installment	12,170	12,219
Total loans	381,083	398,426
Less: unearned income	(378)	(233)
Loans, net of unearned income	$ 380,705	$ 398,193

Loans secured by real estate were approximately 82.4% of the Company s total loan portfolio at September 30, 2013. At September 30, 2013, 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 September 30, 2013, and December 31, 2012.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
September 30, 2013:						
Commercial and industrial	$ 58,260	444	6	58,710	56	$ 58,766
Construction and land development	35,470			35,470	1,592	37,062
Commercial real estate:						
Owner occupied	55,992	49		56,041	1,041	57,082
Other	113,012			113,012	426	113,438
Total commercial real estate	169,004	49		169,053	1,467	170,520
Residential real estate:						
Consumer mortgage	55,814	200	93	56,107	925	57,032
Investment property	44,859	289		45,148	385	45,533
Total residential real estate	100,673	489	93	101,255	1,310	102,565
Consumer installment	12,130	40		12,170		12,170
Total	$ 375,537	1,022	99	376,658	4,425	$ 381,083
December 31, 2012:						
Commercial and industrial	$ 59,101	173		59,274	60	$ 59,334
Construction and land development	35,917	8		35,925	1,706	37,631
Commercial real estate:						
Owner occupied	63,323			63,323	1,045	64,368
Other	113,344	230		113,574	5,669	119,243
Total commercial real estate	176,667	230		176,897	6,714	183,611
Residential real estate:						
Consumer mortgage	55,521	1,202	58	56,781	1,306	58,087
Investment property	46,460	335		46,795	749	47,544
Total residential real estate	101,981	1,537	58	103,576	2,055	105,631
Consumer installment	12,157	62		12,219		12,219
Total	$ 385,823	2,010	58	387,891	10,535	$ 398,426

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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 September 30, 2013 and December 31, 2012, 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.

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The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period. In order to better capture the effects of the current economic cycle on the Company s loan loss experience, the Company calculated average losses for all loan segments (except for the commercial real estate loan segment) using a rolling 8 quarter historical period for the quarter ended June 30, 2013. Based upon management s review of charge-off trends for each loan segment, the Company continued to calculate average losses for the commercial real estate loan segment using a rolling 6 quarter historical period for the quarter ended June 30, 2013. If the Company continued to calculate average losses for all loan segments using a rolling 6 quarter historical period, the Company s calculated allowance for loan loss allocation would have decreased by approximately $1.1 million at June 30, 2013. 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.

						September 30, 2013
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Total**
Quarter ended:						
Beginning balance	$ 675	1,454	3,111	1,125	92	$ 6,457
Charge-offs	(177)	(137)	(103)	(144)		(561)
Recoveries	23	1	21		5	50
Net (charge-offs) recoveries	(154)	(136)	(82)	(144)	5	(511)
Provision	25	(129)	75	1	28	
Ending balance	$ 546	1,189	3,104	982	125	$ 5,946
Nine months ended:						
Beginning balance	$ 812	1,545	3,137	1,126	103	$ 6,723
Charge-offs	(245)	(39)	(262)	(558)	(199)	(1,303)
Recoveries	40	5	4	62	15	126
Net charge-offs	(205)	(34)	(258)	(496)	(184)	(1,177)
Provision	(61)	(322)	225	352	206	400
Ending balance	$ 546	1,189	3,104	982	125	$ 5,946

						September 30, 2012
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Total**
Quarter ended:						
Beginning balance	$ 731	1,623	2,817	1,278	54	6,503
Charge-offs	(152)		(1,626)	(324)	(35)	$ (2,137)
Recoveries	20		71	35	3	$ 129
Net charge-offs	(132)		(1,555)	(289)	(32)	(2,008)
Provision	155	(14)	1,396	(42)	55	$ 1,550
Ending balance	$ 754	1,609	2,658	947	77	$ 6,045
Nine months ended:						

Beginning balance	$ 948	1,470	3,009	1,363	129	$ 6,919
Charge-offs	(246)	(231)	(2,844)	(435)	(68)	(3,824)
Recoveries	28	1	71	85	15	200
Net charge-offs	(218)	(230)	(2,773)	(350)	(53)	(3,624)
Provision	24	369	2,422	(66)	1	2,750
Ending balance	$ 754	1,609	2,658	947	77	$ 6,045

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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 September 30, 2013 and 2012.

	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
September 30, 2013:						
Commercial and industrial	$ 546	58,630		136	546	58,766
Construction and land development	1,090	35,469	99	1,593	1,189	37,062
Commercial real estate	2,919	167,564	185	2,956	3,104	170,520
Residential real estate	982	101,576		989	982	102,565
Consumer installment	125	12,170			125	12,170
Total	$ 5,662	375,409	284	5,674	5,946	381,083
September 30, 2012:						
Commercial and industrial	$ 754	58,395		184	754	58,579
Construction and land development	1,468	36,817	141	3,756	1,609	40,573
Commercial real estate	2,519	175,733	139	8,024	2,658	183,757
Residential real estate	915	101,297	32	2,022	947	103,319
Consumer installment	77	11,747			77	11,747
Total	$ 5,733	383,989	312	13,986	6,045	397,975

(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 in doubt.

(In thousands)	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
September 30, 2013:					
Commercial and industrial	$ 53,776	4,184	750	56	$ 58,766
Construction and land development	34,175	177	1,118	1,592	37,062
Commercial real estate:					
Owner occupied	54,076	1,083	882	1,041	57,082
Other	111,231	963	818	426	113,438
Total commercial real estate	165,307	2,046	1,700	1,467	170,520
Residential real estate:					
Consumer mortgage	49,264	1,147	5,696	925	57,032
Investment property	41,808	1,619	1,721	385	45,533
Total residential real estate	91,072	2,766	7,417	1,310	102,565
Consumer installment	11,970	39	161		12,170
Total	$ 356,300	9,212	11,146	4,425	$ 381,083
December 31, 2012:					
Commercial and industrial	$ 58,487	224	563	60	$ 59,334
Construction and land development	34,490	310	1,125	1,706	37,631
Commercial real estate:					
Owner occupied	59,270	2,528	1,525	1,045	64,368
Other	111,719	653	1,202	5,669	119,243
Total commercial real estate	170,989	3,181	2,727	6,714	183,611
Residential real estate:					
Consumer mortgage	49,462	1,544	5,775	1,306	58,087
Investment property	43,559	1,033	2,203	749	47,544
Total residential real estate	93,021	2,577	7,978	2,055	105,631
Consumer installment	11,850	155	214		12,219
Total	$ 368,837	6,447	12,607	10,535	$ 398,426

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 September 30, 2013 and December 31, 2012.

		September 30, 2013			
(In thousands)		**Unpaid principal balance (1)**	**Charge-offs and payments applied (2)**	**Recorded investment (3)**	**Related allowance**
With no allowance recorded:					
Commercial and industrial	$	136		136	
Construction and land development		2,879	(1,682)	1,197	
Commercial real estate:					
Owner occupied		1,220	(180)	1,040	
Other		516	(90)	426	
Total commercial real estate		1,736	(270)	1,466	
Residential real estate:					
Consumer mortgages		958	(186)	772	
Investment property		340	(123)	217	
Total residential real estate		1,298	(309)	989	
Total	$	6,049	(2,261)	3,788	