UNITY BANCORP INC /NJ/
Form 10-Q
November 10, 2009

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, 2009

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ____ TO ____.

Commission file number 1-12431

Unity Bancorp, Inc.
(Exact Name of Registrant as Specified in Its Charter)

New Jersey (State or Other Jurisdiction of Incorporation or Organization)	22-3282551 (I.R.S. Employer Identification No.)
64 Old Highway 22, Clinton, NJ (Address of Principal Executive Offices)	08809 (Zip Code)

Registrant’s Telephone Number, Including Area Code (908) 730-7630

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, as amended, during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a nonaccelerated filer (as defined in Exchange Act Rule 12b-2):
Large accelerated filer o Accelerated filer o Nonaccelerated filer o Smaller reporting company x

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

The number of shares outstanding of each of the registrant's classes of common equity stock, as of November 1, 2009 common stock, no par value: 7,119,438 shares outstanding

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Item 1 - Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.
Consolidated Balance Sheets
(Unaudited)

(In thousands)	September 30, 2009	December 31, 2008	September 30, 2008
ASSETS			
Cash and due from banks	$ 17,035	$ 18,902	$ 21,987
Federal funds sold and interest-bearing deposits	48,853	15,529	29,356
Cash and cash equivalents	65,888	34,431	51,343
Securities:			
Available for sale	140,906	117,348	70,144
Held to maturity (fair value of $30,396, $30,088 and $27,063, respectively)	30,595	32,161	29,266
Total securities	171,501	149,509	99,410
Loans:			
SBA held for sale	21,364	22,181	19,863
SBA held to maturity	79,342	83,127	82,551
SBA 504	71,432	76,802	82,227
Commercial	298,019	308,165	311,988
Residential mortgage	124,313	133,110	128,216
Consumer	62,050	62,561	60,178
Total loans	656,520	685,946	685,023
Less: Allowance for loan losses	12,445	10,326	9,913
Net loans	644,075	675,620	675,110
Premises and equipment, net	11,911	12,580	12,475
Bank owned life insurance	5,946	5,780	5,727
Federal Home Loan Bank stock	4,677	4,857	5,307
Accrued interest receivable	4,230	4,712	4,364
Goodwill and other intangibles	1,563	1,574	1,577
Loan servicing asset	977	1,503	1,721
Other assets	11,921	7,744	7,049
Total Assets	$ 922,689	$ 898,310	$ 864,083
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Deposits:			
Noninterest-bearing demand deposits	$ 83,534	$ 74,090	$ 82,167
Interest-bearing demand deposits	92,401	87,046	87,587
Savings deposits	263,758	134,875	148,026
Time deposits, under $100,000	209,050	270,275	274,845
Time deposits, $100,000 and over	101,922	140,831	92,055
Total deposits	750,665	707,117	684,680
Borrowed funds	85,000	105,000	115,000
Subordinated debentures	15,465	15,465	15,465

Accrued interest payable	797	805	869
Accrued expenses and other liabilities	3,377	2,120	1,530
Total Liabilities	855,304	830,507	817,544
Commitments and contingencies	-	-	-
Shareholders' equity:			
Preferred stock, no par value, 500 shares authorized	18,418	18,064	-
Common stock, no par value, 12,500 shares authorized	55,351	55,179	52,453
Retained earnings (deficit)	(1,253)	1,085	591
Treasury stock at cost	(4,169)	(4,169)	(4,169)
Accumulated other comprehensive loss, net of tax	(962)	(2,356)	(2,336)
Total Shareholders' Equity	67,385	67,803	46,539
Total Liabilities and Shareholders' Equity	$ 922,689	$ 898,310	$ 864,083
Preferred shares	21	21	-
Issued common shares	7,544	7,544	7,535
Outstanding common shares	7,119	7,119	7,110

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

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Unity Bancorp
Consolidated Statements of Operations
(Unaudited)

(In thousands, except per share amounts)	For the three months ended September 30, 2009	For the three months ended September 30, 2008	For the nine months ended September 30, 2009	For the nine months ended September 30, 2008
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	$32	$ 113	$78	$ 404
Federal Home Loan Bank stock	101	58	219	234
Securities:				
Available for sale	1,482	907	4,670	2,714
Held to maturity	389	381	1,167	1,216
Total securities	1,871	1,288	5,837	3,930
Loans:				
SBA	1,498	2,043	4,668	6,399
SBA 504	1,147	1,424	3,663	4,134
Commercial	4,973	5,453	15,040	16,145
Residential mortgage	1,772	1,720	5,419	4,008
Consumer	791	866	2,383	2,613
Total loan interest income	10,181	11,506	31,173	33,299
Total interest income	12,185	12,965	37,307	37,867
INTEREST EXPENSE				
Interest-bearing demand deposits	264	404	801	1,120
Savings deposits	1,032	774	2,588	3,041
Time deposits	2,950	3,553	10,084	9,779
Borrowed funds and subordinated debentures	1,081	1,152	3,344	3,372
Total interest expense	5,327	5,883	16,817	17,312
Net interest income	6,858	7,082	20,490	20,555
Provision for loan losses	3,000	2,100	6,000	3,200
Net interest income after provision for loan losses	3,858	4,982	14,490	17,355
NONINTEREST INCOME (LOSS)				
Service charges on deposit accounts	373	381	1,038	1,042
Service and loan fee income	398	334	946	936
Bank owned life insurance	56	53	166	157
Gain on sale of mortgage loans	71	-	184	21
Gain on sale of SBA loans held for sale, net	-	215	29	1,208
Total other-than-temporary impairment charge on securities	-	(946)	(2,555)	(1,201)
Portion of loss recognized in other comprehensive income (before taxes)	-	-	806	-
Net other-than temporary impairment charge recognized in earnings	-	(946)	(1,749)	(1,201)
Net security gains (losses)	158	(512)	675	(393)
Other income	106	131	316	369
Total noninterest income (loss)	1,162	(344)	1,605	2,139
NONINTEREST EXPENSE				
Compensation and benefits	2,909	2,948	8,386	9,148
Occupancy	595	688	1,929	2,102

Processing and communications	531	554	1,554	1,668
Furniture and equipment	414	423	1,381	1,224
Professional services	274	285	780	626
Loan collection costs	315	206	694	446
Deposit insurance	351	117	1,361	291
Advertising	147	158	373	299
Other expenses	574	400	1,411	1,362
Total noninterest expense	6,110	5,779	17,869	17,166
Income (loss) before provision for income taxes	(1,090)	(1,141)	(1,774)	2,328
Provision (benefit) for income taxes	(343)	(139)	(559)	982
Net (loss) income	(747)	(1,002)	(1,215)	1,346
Preferred stock dividends and discount accretion	372	-	1,123	-
Income available (loss attributable) to common shareholders	$(1,119)	$ (1,002)	$(2,338)	$ 1,346
Net income (loss) per common share - Basic	$(0.16)	$ (0.14)	$(0.33)	$ 0.19
- Diluted	(0.16)	(0.14)	(0.33)	0.19
Weighted average common shares outstanding - Basic	7,119	7,107	7,119	7,091
- Diluted	7,119	7,107	7,119	7,268

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity
For the nine months ended September 30, 2009 and 2008
(Unaudited)

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, December 31, 2007	$	7,063	$ 49,447	$ 2,472	$ (4,169)	$ (490)	$ 47,260
Comprehensive income:							
Net income				1,346			1,346
Unrealized losses on securities, net of tax						(1,727)	(1,727)
Unrealized losses on cash flow hedge derivatives, net of tax						(119)	(119)
Total comprehensive loss							(500)
Dividends on common stock ($.10 per share)				(692)			(692)
5% stock dividend, including cash-in-lieu			2,532	(2,535)			(3)
Issuance of common stock:							
Stock issued, including related tax benefits		34	240				240
Stock-based compensation		13	234				234
Balance, September 30, 2008	$	7,110	$ 52,453	$ 591	$ (4,169)	$ (2,336)	$ 46,539

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, December 31, 2008	$ 18,064	7,119	$ 55,179	$ 1,085	$ (4,169)	$ (2,356)	$ 67,803
Comprehensive income:							

Net loss				(1,215)			(1,215)
Noncredit unrealized losses on held to maturity debt securities, net of tax						(532)	(532)
Unrealized gains on securities, net of tax						1,841	1,841
Unrealized gains on cash flow hedge derivatives, net of tax						85	85
Total comprehensive income							179
Accretion of discount on preferred stock	354			(354)			-
Dividends on preferred stock (5% annually)				(769)			(769)
Issuance of common stock:							
Stock issued, including related tax benefits			(51)				(51)
Stock-based compensation			223				223
Balance, September 30, 2009	$ 18,418	7,119	$ 55,351	$ (1,253)	$ (4,169)	$ (962)	$ 67,385

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

(In thousands)	For the nine months ended September 30, 2009	September 30, 2008
OPERATING ACTIVITIES:		
Net (loss) income	$ (1,215)	$ 1,346
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	6,000	3,200
Net amortization of purchase premiums and discounts on securities	327	55
Depreciation and amortization	1,115	626
Deferred income tax benefit	(2,091)	(1,515)
Other-than-temporary impairment charges on securities	1,749	1,201
Net security (gains) losses	(675)	393
Stock compensation expense	223	234
Gain on sale of SBA loans held for sale, net	(29)	(1,208)
Gain on sale of mortgage loans	(184)	(21)
Loss on disposal of fixed assets	-	28
Origination of mortgage loans held for sale	(15,700)	(1,739)
Origination of SBA loans held for sale	(1,910)	(25,846)
Proceeds from the sale of mortgage loans held for sale, net	15,884	1,760
Proceeds from the sale of SBA loans held for sale, net	867	26,041
Net change in other assets and liabilities	1,960	110
Net cash provided by operating activities	6,321	4,665
INVESTING ACTIVITIES		
Purchases of securities held to maturity	(4,036)	(2,782)
Purchases of securities available for sale	(87,708)	(30,337)
Purchases of Federal Home Loan Bank stock, at cost	(8,469)	(1,362)
Maturities and principal payments on securities held to maturity	4,096	9,098
Maturities and principal payments on securities available for sale	39,665	15,757
Proceeds from sales of securities available for sale	26,048	3,696
Proceeds from the redemption of Federal Home Loan Bank stock	8,649	450
Proceeds from the sale of other real estate owned	1,171	353
Net decrease (increase) in loans	23,245	(96,066)
Proceeds from the sale of premises and equipment	-	263
Purchases of premises and equipment	(305)	(1,326)
Net cash provided by (used in) investing activities	2,356	(102,257)

FINANCING ACTIVITIES				
Net increase in deposits		43,548		83,412
Proceeds from new borrowings		22,000		35,000
Repayments of borrowings		(42,000)		(5,000)
Proceeds from the issuance of common stock		(51)		240
Cash dividends paid on preferred stock		(717)		-
Cash dividends paid on common stock		-		(1,028)
Net cash provided by financing activities		22,780		112,623
Increase in cash and cash equivalents		31,457		15,031
Cash and cash equivalents at beginning of period		34,431		36,312
Cash and cash equivalents at end of period	$	65,888	$	51,343
SUPPLEMENTAL DISCLOSURES				
Cash:				
Interest paid	$	16,825	$	17,078
Income taxes paid		1,035		1,391
Noncash investing activities:				
Transfer of AFS securities to HTM securities		-		1,860
Transfer of AFS SBA loans to HTM SBA loans		1,890		5,790
Transfer of loans to other real estate owned		3,242		565

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)
September 30, 2009

NOTE 1. Significant Accounting Policies

The accompanying consolidated financial statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank’s investment portfolio. Unity Participation Company, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank’s loan portfolio. All significant inter-company balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the statements of financial condition and revenues and expenses during the reporting periods. Actual results could differ from those estimates. The Company has evaluated subsequent events for potential recognition and/or disclosure through November 10, 2009, the date the consolidated financial statements included in this Quarterly Report on Form 10-Q were issued.

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission (“SEC”). The results of operations for the nine months ended September 30, 2009 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, “we” and “us” and “our” refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Interim financial statements should be read in conjunction with the Company’s consolidated financial statements and notes thereto for the year ended December 31, 2008, included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2008.

Accounting Standards Codification

The Financial Accounting Standards Board’s ("FASB") Accounting Standards Codification ("ASC") became effective on July 1, 2009. At that date, the ASC became FASB’s officially recognized source of authoritative U.S. generally accepted accounting principles ("GAAP") applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF") and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

Stock Transactions

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. In addition, restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time.

Stock Option Plans

The Company's incentive and nonqualified option plans permit the Board to set vesting requirements. Grants issued to date generally vest over 3 years and must be exercised within 10 years of the date of the grant. The exercise price of each option is the market price on the date of grant. As of September 30, 2009, 1,520,529 shares have been reserved for issuance upon the exercise of options, 833,612 option grants are outstanding, and 572,271 option grants have been exercised, forfeited or expired, leaving 114,646 shares available for grant.

The Company did not grant any options during the three months and nine months ended September 30, 2009. Comparatively, 5,000 and 47,263 options were granted during the three months and nine months ended September 30, 2008, respectively. The fair value of the options granted during 2008 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Number of shares granted	-	5,000	-	47,263
Weighted average exercise price	$ -	6.12	$ -	$ 7.44
Weighted average fair value	$ -	1.42	$ -	$ 1.58
Expected life	-	3.99	-	3.82
Expected volatility	-%	34.14	- %	31.33%
Risk-free interest rate	-%	3.15	- %	2.51%
Dividend yield	-%	3.27	- %	2.59%

Transactions under the Company's stock option plans during the nine months ended September 30, 2009 are summarized as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2008	872,274	$ 5.94		
Options expired	(37,395)	8.02		
Options forfeited	(1,267)	5.38		
Outstanding at September 30, 2009	833,612	$ 5.85	4.4	$ 360,793
Exercisable at September 30, 2009	656,762	$ 5.82	3.3	$ 331,993

FASB ASC Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options totaled $43 thousand and $38 thousand for the three months ended September 30, 2009 and 2008, respectively. The related income tax benefit was approximately $18 thousand and $16 thousand for each of the three months ended September 30, 2009 and 2008, respectively. Compensation expense related to stock options totaled $115 thousand and $105 thousand for the nine months ended September 30, 2009 and 2008, respectively. The related income tax benefit was approximately $54 thousand and $45 thousand for each of the nine months ended September 30, 2009 and 2008, respectively. As of

September 30, 2009, there was approximately $185 thousand of unrecognized compensation cost related to nonvested, share-based compensation arrangements granted under the Company's stock incentive plans. This cost is expected to be recognized over a weighted-average period of 1.7 years.

There were no options exercised during the three months and nine months ended September 30, 2009 or the three months ended September 30, 2008; consequently, no intrinsic value was realized. During the nine months ended September 30, 2008, there were 536 shares exercised with a related intrinsic value (spread between the market value and exercise price) of $1 thousand.

Restricted Stock Awards

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value and amortized into salary expense on a straight line basis over the vesting period. There were no restricted stock awards granted during the three months and nine months ended September 30, 2009. There were 1,500 restricted share awards with an average grant date fair value of $6.12 and 14,100 restricted share awards with an average grant date fair value of $7.43 granted during the three months and nine months ended September 30, 2008, respectively.

Compensation expense related to the restricted stock awards totaled $46 thousand and $45 thousand for the three months ended September 30, 2009 and 2008, respectively. Compensation expense related to the restricted stock awards totaled $108 thousand and $129 thousand for the nine months ended September 30, 2009 and 2008, respectively. As of September 30, 2009 there was approximately $182 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. The cost is expected to be recognized over a weighted average period of 1.8 years.

As of September 30, 2009, 121,551 shares of restricted stock were reserved for issuance, of which 44,508 shares are available for grant.

The following table summarizes nonvested restricted stock award activity for the nine months ended September 30, 2009:

	Shares	Average Grant Date Fair Value
Nonvested restricted stock at December 31, 2008	50,424	$ 9.76
Granted	-	-
Vested	(15,418)	11.30
Forfeited	-	-
Nonvested restricted stock at September 30, 2009	35,006	$ 9.08

Income Taxes

The Company accounts for income taxes according to the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision.

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 ultimately would be 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. The evaluation of a tax position taken is considered by itself and 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 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 and penalties associated with unrecognized tax benefits are recognized in income tax expense on the income statement.

Derivative Instruments and Hedging Activities

The Company uses derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. As of September 30, 2009, all of the Company's derivative instruments qualified as hedging instruments.

For those derivative instruments that are designated and qualify as hedging instruments, the Company must designate the hedging instrument, based on the exposure being hedged, as a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation. The Company does not have any fair value hedges or hedges of foreign operations.

The Company formally documents the relationship between the hedging instruments and hedged item, as well as the risk management objective and strategy before undertaking a hedge. To qualify for hedge accounting, the derivatives and hedged items must be designated as a hedge. For hedging relationships in which effectiveness is measured, the Company formally assesses, both at inception and on an ongoing basis, if the derivatives are highly effective in offsetting changes in fair values or cash flows of the hedged item. If it is determined that the derivative instrument is not highly effective as a hedge, hedge accounting is discontinued.

For derivatives that are designated as cash flow hedges, the effective portion of the gain or loss on derivatives is reported as a component of other comprehensive income or loss and subsequently reclassified in interest income in the same period during which the hedged transaction affects earnings. As a result, the change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings.

The Company will discontinue hedge accounting when it is determined that the derivative is no longer qualifying as an effective hedge; the derivative expires or is sold, terminated or exercised; or the derivative is de-designated as a fair value or cash flow hedge or it is no longer probable that the forecasted transaction will occur by the end of the originally specified time period. If the Company determines that the derivative no longer qualifies as a cash flow or fair value hedge and therefore hedge accounting is discontinued, the derivative will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings.

Loans Held To Maturity and Loans Held For Sale

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and net of deferred loan origination fees and costs. Loan origination fees, net of direct loan origination costs, are deferred and are recognized over the estimated life of the related loans as an adjustment to the loan yield utilizing the level yield method.

Interest is credited to operations primarily based upon the principal amount outstanding. When management believes there is sufficient doubt as to the ultimate collectability of interest on any loan, interest accruals are discontinued and all past due interest, previously recognized as income, is reversed and charged against current period earnings. Payments received on nonaccrual loans are applied as principal. Loans are returned to an accrual status when collectability is reasonably assured and when the loan is brought current as to principal and interest.

Loans are reported as past due when either interest or principal is unpaid in the following circumstances: fixed payment loans when the borrower is in arrears for two or more monthly payments; open end credit for two or more billing cycles; and single payment notes if interest or principal remains unpaid for 30 days or more.

Loans are charged off when collection is sufficiently questionable and when the Bank can no longer justify maintaining the loan as an asset on the balance sheet. Loans qualify for charge off when, after thorough analysis, all possible sources of repayment are insufficient. These include: 1) potential future cash flow, 2) value of collateral, and/or 3) strength of co-makers and guarantors. All unsecured loans are charged off upon the establishment of the loan's nonaccrual status. Additionally, all loans classified as a loss or that portion of the loan classified as a loss, are charged off. All loan charge-offs are approved by the Board of Directors.

Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the collectability of principal and interest according to the contractual terms is in doubt. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income.

The Company evaluates its loans for impairment. A loan is considered 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. The Company has defined impaired loans to be all troubled debt restructurings and nonaccrual loans. Impairment of a loan is measured based on the present value of expected future cash flows, net of estimated costs to sell, discounted at the loan's effective interest rate. Impairment can also be measured based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge or credit to the provision for loan losses.

Loans held for sale are SBA loans and are reflected at the lower of aggregate cost or market value.

The Company originates loans to customers under an SBA program that generally provides for SBA guarantees up to 90 percent of each loan. In the past, the Company generally sold the guaranteed portion of its SBA loans to a third party and retained the servicing, holding the nonguaranteed portion in its portfolio. However, during the third quarter of 2007, the Company announced a change in its strategy to retain more SBA loans in its portfolio due to lower premiums received on the sale of these loans. During late 2008, the Company withdrew from SBA lending as a primary line of business, but continues to offer SBA loan products as an additional credit product to its customers. If sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing asset are recognized in income.

Serviced loans sold to others are not included in the accompanying consolidated balance sheets. Income and fees collected for loan servicing are credited to noninterest income when earned, net of amortization on the related servicing asset.

For additional information see the section titled "Loan Portfolio" under Item 2. Management's Discussion and Analysis.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level management considers adequate to provide for probable loan losses as of the balance sheet date. The allowance is increased by provisions charged to expense and is reduced by net charge-offs.

The level of the allowance is based on management's evaluation of probable losses in the loan portfolio, after consideration of prevailing economic conditions in the Company's market area, the volume and composition of the loan portfolio, and historical loan loss experience. The allowance for loan losses consists of specific reserves for individually impaired credits, reserves for nonimpaired loans based on historical loss factors and reserves based on general economic factors and other qualitative risk factors such as changes in delinquency trends, industry concentrations or local/national economic trends. This risk assessment process is performed at least quarterly, and, as adjustments become necessary, they are realized in the periods in which they become known.

Although management attempts to maintain the allowance at a level deemed adequate to provide for probable losses, future additions to the allowance may be necessary based upon certain factors including changes in market conditions and underlying collateral values. In addition, various regulatory agencies periodically review the adequacy of the Company's allowance for loan losses. These agencies may require the Company to make additional provisions based on their judgments about information available to them at the time of their examination.

For additional information, see the sections titled "Asset Quality" and "Allowance for Loan Losses" under Item 2. Management's Discussion and Analysis.

NOTE 2. Litigation

From time to time, the Company is subject to legal proceedings and claims in the ordinary course of business. The Company currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or the results of the operation of the Company.

NOTE 3. Earnings per share

Basic net income (loss) per common share is calculated as net income available (loss attributable) to common shareholders divided by the weighted average common shares outstanding during the reporting period. Net income available (loss attributable) to common shareholders is calculated as net income (loss) less accrued dividends and discount accretion related to preferred stock.

Diluted net income (loss) per common share is computed similarly to that of basic net income (loss) per common share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options, were issued during the reporting period utilizing the Treasury stock method. However, when a net loss is recognized rather than net income, diluted earnings per share equals basic earnings per share.

The following is a reconciliation of the calculation of basic and diluted earnings per share.

	Three Months ended September 30,		Nine Months ended September 30,	
(In thousands, except per share data)	2009	2008	2009	2008
Net income (loss)	$ (747)	$ (1,002)	$ (1,215)	$ 1,346
Less: Preferred stock dividends and discount accretion	372	-	1,123	-
Net income available (loss attributable) to common shareholders	$ (1,119)	$ (1,002)	$ (2,338)	$ 1,346
Weighted-average common shares outstanding (basic)	7,119	7,107	7,119	7,091
Plus: Effect of dilutive securities	-	-	-	177
Weighted-average common shares outstanding (diluted)	7,119	7,107	7,119	7,268
Net income (loss) per common share:				
Basic	$ (0.16)	$ (0.14)	$ (0.33)	$ 0.19
Diluted	(0.16)	(0.14)	(0.33)	0.19
Stock options and common stock warrants excluded from the earnings per share computation as their effect would have been anti-dilutive	1,385	405	1,405	387

The number of anti-dilutive stock options and common stock warrants for the three and nine months ended September 30, 2009 include the issuance of common stock warrants to the U.S. Department of Treasury under the Capital Purchase Program in December 2008.

NOTE 4. Income Taxes

The Company follows FASB ASC Topic 740, "Income Taxes," which prescribes a recognition threshold and measurement attribute criteria for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return, as well as guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The Company did not recognize or accrue any interest or penalties related to income taxes during the three month and nine month periods ended September 30, 2009 and 2008. The Company does not have an accrual for uncertain tax positions as of September 30, 2009, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. The tax years 2005-2008 remain open to examination by the major taxing jurisdictions to which the Company is subject.

NOTE 5. Other Comprehensive Income (Loss)

(In thousands)	For the three months ended September 30, 2009	2008	For the nine months ended September 30, 2009	2008
Net income (loss)	$(747)	$(1,002)	$(1,215)	$1,346
Unrealized gains (losses) on available for sale securities	492	(882)	1,401	(1,362)
Noncredit unrealized losses on HTM debt securities	-	-	(806)	-
Unrealized gains (losses) on cash flow hedge derivatives	(48)	(153)	137	(192)
Income tax (expense) benefit	796	453	662	(292)
Total comprehensive income (loss)	$493	$(1,584)	$179	$(500)

NOTE 6. Fair Value

Fair Value Measurement

The Company follows FASB ASC Topic 820, "Fair Value Measurement and Disclosures," which requires additional disclosures about the Company's assets and liabilities that are measured at fair value. Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company uses various methods including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company utilizes techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Based on the observability of the inputs used in valuation techniques the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed as follows:

Level 1 Inputs

Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Generally, this includes debt and equity securities and derivative contracts that are traded in an active exchange market (i.e. New York Stock Exchange), as well as certain US Treasury and US Government and agency mortgage-backed securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Inputs

Quoted prices for similar assets or liabilities in active markets.

Quoted prices for identical or similar assets or liabilities.

Inputs other than quoted prices that are observable, either directly or indirectly, for the term of the asset or liability (e.g., interest rates, yield curves, credit risks, prepayment speeds or volatilities) or "market corroborated inputs."

Generally, this includes US Government and agency mortgage-backed securities, corporate debt securities, derivative contracts and loans held for sale.

Level 3 Inputs

Prices or valuation techniques that require inputs that are both unobservable (i.e. supported by little or no market activity) and that are significant to the fair value of the assets or liabilities.

These assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair Value on a Recurring Basis

The following is a description of the valuation methodologies used for instruments measured at fair value:

Available for Sale Securities Portfolio -

The fair value of available for sale securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

SBA Servicing Rights –

SBA servicing rights do not trade in an active, open market with readily observable prices. The Company estimates the fair value of SBA servicing rights using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including market discount rates and prepayment speeds. The fair value of SBA servicing rights as of September 30, 2009 was determined using a discount rate of 15 percent, constant prepayment rates of 15 to 18 CPR, and interest strip multiples ranging from 2.08 to 3.80, depending on each individual credit. Due to the nature of the valuation inputs, SBA servicing rights are classified as Level 3 assets.

Interest rate swap agreements -

Based on the complex nature of interest rate swap agreements, the markets these instruments trade in are not as efficient and are less liquid than that of Level 1 markets. These markets do, however, have comparable, observable inputs in which an alternative pricing source values these assets or liabilities in order to arrive at a fair value. The fair values of our interest swaps are measured based on the difference between the yield on the existing swaps and the yield on current swaps in the market (i.e. The Yield Book); consequently, they are classified as Level 2 instruments.

There were no changes in the inputs or methodologies used to determine fair value during the quarter ended September 30, 2009 as compared to the quarters ended December 31, 2008 and September 30, 2008. The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of September 30, 2009 and December 31, 2008.

	As of September 30, 2009			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				