JUNIATA VALLEY FINANCIAL CORP
Form 10-Q
May 08, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT 1934

For the quarterly period ended March 31, 2014

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________________________ to _____________________________

Commission File Number __________________________ 000-13232 __________________________

Juniata Valley Financial Corp
(Exact name of registrant as specified in its charter)

Pennsylvania	23-2235254
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Bridge and Main Streets, Mifflintown, Pennsylvania	17059
(Address of principal executive offices)	(Zip Code)

(717) 436-8211
(Registrant's telephone number, including area code)

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.

x Yes ¨ No

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

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

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

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

¨ Yes x No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding as of May 8, 2014
Common Stock ($1.00 par value)	4,196,266 shares

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Juniata Valley Financial Corp. and Subsidiary

Consolidated Statements of Financial Condition

(Unaudited, in thousands, except share data)

	March 31, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$ 10,570	$ 8,570
Interest bearing deposits with banks	4,318	43
Cash and cash equivalents	14,888	8,613
Interest bearing time deposits with banks	249	249
Securities available for sale	124,515	126,046
Restricted investment in Federal Home Loan Bank (FHLB) stock	1,602	1,967
Investment in unconsolidated subsidiary	4,199	4,172
Total loans	275,983	277,798
Less: Allowance for loan losses	(2,300)	(2,287)
Total loans, net of allowance for loan losses	273,683	275,511
Premises and equipment, net	6,246	6,330
Other real estate owned	340	281
Bank owned life insurance and annuities	14,953	14,848
Investment in low income housing partnership	4,203	3,990
Core deposit intangible	108	119
Goodwill	2,046	2,046
Mortgage servicing rights	169	167
Accrued interest receivable and other assets	4,709	4,443
Total assets	$ 451,910	$ 448,782
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Non-interest bearing	$ 80,661	$ 74,611
Interest bearing	311,720	305,034
Total deposits	392,381	379,645
Securities sold under agreements to repurchase	4,038	5,397
Short-term borrowings	-	8,400
Other interest bearing liabilities	1,357	1,356
Accrued interest payable and other liabilities	3,784	4,000

Total liabilities	401,560	398,798
Stockholders' Equity:		
Preferred stock, no par value:		
Authorized - 500,000 shares, none issued	-	-
Common stock, par value $1.00 per share:		
Authorized - 20,000,000 shares		
Issued - 4,745,826 shares		
Outstanding -		
4,196,266 shares at March 31, 2014;		
4,196,266 shares at December 31, 2013	4,746	4,746
Surplus	18,380	18,370
Retained earnings	39,098	39,118
Accumulated other comprehensive loss	(1,283)	(1,659)
Cost of common stock in Treasury:		
549,560 shares at March 31, 2014;		
549,560 shares at December 31, 2013	(10,591)	(10,591)
Total stockholders' equity	50,350	49,984
Total liabilities and stockholders' equity	$ 451,910	$ 448,782

See Notes to Consolidated Financial Statements

Juniata Valley Financial Corp. and Subsidiary

Consolidated Statements of Income

(Unaudited, in thousands, except share and per share data)

	Three Months Ended March 31,	
	2014	2013
Interest income:		
Loans, including fees	$3,550	$3,690
Taxable securities	355	297
Tax-exempt securities	130	151
Other interest income	1	6
Total interest income	4,036	4,144
Interest expense:		
Deposits	621	757
Securities sold under agreements to repurchase	1	1
Short-term borrowings	1	-
Other interest bearing liabilities	4	5
Total interest expense	627	763
Net interest income	3,409	3,381
Provision for loan losses	20	80
Net interest income after provision for loan losses	3,389	3,301
Non-interest income:		
Customer service fees	268	310
Debit card fee income	203	194
Earnings on bank-owned life insurance and annuities	97	97
Trust fees	76	89
Commissions from sales of non-deposit products	112	116
Income from unconsolidated subsidiary	37	54
Fees derived from loan activity	38	60
Gain on sales of loans	29	96
Gain on sales and calls of securities	5	1
Other non-interest income	55	60
Total non-interest income	920	1,077
Non-interest expense:		
Employee compensation expense	1,352	1,223
Employee benefits	403	462
Occupancy	282	245
Equipment	114	120
Data processing expense	380	354
Director compensation	57	57
Professional fees	99	95
Taxes, other than income	107	123
FDIC Insurance premiums	81	90

Gain on sales of other real estate owned	(18)	(26)
Amortization of intangibles	11	11
Amortization of investment in low-income housing partnership	120	-
Other non-interest expense	348	281
Total non-interest expense	3,336	3,035
Income before income taxes	973	1,343
Provision for income taxes	70	337
Net income	$903	$1,006
Earnings per share		
Basic	$0.22	$0.24
Diluted	$0.22	$0.24
Cash dividends declared per share	$0.22	$0.22
Weighted average basic shares outstanding	4,196,266	4,218,361
Weighted average diluted shares outstanding	4,196,614	4,219,526

See Notes to Consolidated Financial Statements

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Juniata Valley Financial Corp. and Subsidiary

Consolidated Statements of Comprehensive Income

(Unaudited, in thousands)

	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
	Before Tax Amount	Tax Effect	Net of Tax Amount	Before Tax Amount	Tax Effect	Net of Tax Amount
Net income	$ 973	$ (70)	$ 903	$ 1,343	$ (337)	$ 1,006
Other comprehensive income (loss):						
Unrealized gains (losses) on available for sale securities:						
Unrealized holding gains (losses) arising during the period	555	(188)	367	(39)	13	(26)
Unrealized holding gains (losses) from unconsolidated subsidiary	6	-	6	(5)	-	(5)
Less reclassification adjustment for gains included in net income (1) (3)	(5)	2	(3)	(1)	-	(1)
Amortization of pension net actuarial cost (2) (3)	10	(4)	6	51	(17)	34
Other comprehensive income	566	(190)	376	6	(4)	2
Total comprehensive income	$ 1,539	$ (260)	$ 1,279	$ 1,349	$ (341)	$ 1,008

See Notes to Consolidated Financial Statements

(1) Amounts are included in gain on calls of securities on the Consolidated Statements of Income as a separate element within total non-interest income.

(2) Amounts are included in the computation of net periodic benefit cost and are included in employee benefits expense on the Consolidated Statements of Income as a separate element within total non-interest expense.

(3) Income tax amounts are included in the provision for income taxes on the Consolidated Statements of Income.

Juniata Valley Financial Corp. and Subsidiary

Consolidated Statements of Stockholders' Equity

(Unaudited, in thousands, except share data)

Three Months Ended March 31, 2014

	Number of Shares Outstanding	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Stockholders' Equity
Balance at January 1, 2014	4,196,266	$ 4,746	$ 18,370	$ 39,118	$ (1,659)	$ (10,591)	$ 49,984
Net income				903			903
Other comprehensive income					376		376
Cash dividends at $0.22 per share				(923)			(923)
Stock-based compensation			10				10
Balance at March 31, 2014	4,196,266	$ 4,746	$ 18,380	$ 39,098	$ (1,283)	$ (10,591)	$ 50,350

Three Months Ended March 31, 2013

	Number of Shares **Outstanding**	Common **Stock**	**Surplus**	Retained **Earnings**	Accumulated Other Comprehensive **Loss**	Treasury **Stock**	Total Stockholders' **Equity**
Balance at January 1, 2013	4,218,361	$ 4,746	$ 18,346	$ 38,824	$ (1,419)	$ (10,200)	$ 50,297
Net income				1,006			1,006
Other comprehensive income					2		2
Cash dividends at $0.22 per share				(928)			(928)
Stock-based compensation			6				6
Balance at March 31, 2013	4,218,361	$ 4,746	$ 18,352	$ 38,902	$ (1,417)	$ (10,200)	$ 50,383

See Notes to Consolidated Financial Statements

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Juniata Valley Financial Corp. and Subsidiary

Consolidated Statements of Cash Flows

(Unaudited, in thousands)

	Three Months Ended March 31,	
Operating activities:	2014	2013
Net income	$ 903	$ 1,006
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	20	80
Depreciation	120	131
Net amortization of securities premiums	106	111
Net amortization of loan origination (fees) costs	(22)	13
Deferred net loan origination costs	(51)	(2)
Amortization of core deposit intangible	11	11
Amortization of investment in low income housing partnership	120	-
Net realized gain on calls and sales of securities	(5)	(1)
Net gain on sales of other real estate owned	(18)	(26)
Earnings on bank owned life insurance and annuities	(97)	(97)
Deferred income tax expense	26	29
Equity in earnings of unconsolidated subsidiary, net of dividends of $16 and $15	(21)	(39)
Stock-based compensation expense	10	6
Mortgage loans originated for sale	(392)	(3,690)
Proceeds from loans sold to others	421	3,382
Gains on sales of loans	(29)	(96)
Increase in accrued interest receivable and other assets	(474)	(431)
Decrease in accrued interest payable and other liabilities	(206)	(249)
Net cash provided by operating activities	422	138
Investing activities:		
Purchases of:		
Securities available for sale	(12,681)	(14,227)
Premises and equipment	(36)	(11)
Bank owned life insurance and annuities	(19)	(18)
Proceeds from:		
Sales of securities available for sale	2,150	-
Maturities of and principal repayments on securities available for sale	12,511	7,333
Redemption of FHLB stock	365	254
Bank owned life insurance and annuities	2	2
Sale of other real estate owned	39	354
Sale of other assets	-	2
Investment in low income housing partnership	(333)	(150)
Net decrease in loans	1,801	4,274
Net cash provided by (used in) investing activities	3,799	(2,187)
Financing activities:		
Net increase in deposits	12,736	1,727

Net change in short-term borrowings and securities sold under agreements to repurchase	(9,759)	(1,608)
Cash dividends	(923)	(928)
Net cash provided by (used in) financing activities	2,054	(809)
Net increase (decrease) in cash and cash equivalents	6,275	(2,858)
Cash and cash equivalents at beginning of year	8,613	14,397
Cash and cash equivalents at end of period	$ 14,888	$ 11,539
Supplemental information:		
Interest paid	$ 649	$ 791
Income taxes paid	-	75
Supplemental schedule of noncash investing and financing activities:		
Transfer of loans to other real estate owned	$ 80	$ 62

See Notes to Consolidated Financial Statements

JUNIATA VALLEY FINANCIAL CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Basis of Presentation and Accounting Policies

The consolidated financial statements include the accounts of Juniata Valley Financial Corp. (the "Company") and its wholly owned subsidiary, The Juniata Valley Bank (the "Bank"). All significant intercompany accounts and transactions have been eliminated.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (U.S. GAAP) for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for fair presentation have been included. Operating results for the three month period ended March 31, 2014, are not necessarily indicative of the results for the year ending December 31, 2014. For further information, refer to the consolidated financial statements and notes thereto included in Juniata Valley Financial Corp.'s Annual Report on Form 10-K for the year ended December 31, 2013.

The Company has evaluated events and transactions occurring subsequent to the consolidated statement of financial condition date of March 31, 2014 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

2. Recent Accounting Standards Updates (ASU)

Accounting Standards Update 2014-01, ***Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)***

Issued: January 2014

Summary: The Low Income Housing Tax Credit is a program designed to encourage investment of private capital for use in the construction and rehabilitation of low income housing, which provides certain tax benefits to investors in those projects. The amendments in this Update permit a reporting entity that invests in qualified affordable housing projects to account for the investments using a proportional amortization method if certain conditions are met. If an entity elects the proportional amortization method, it will amortize the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognize the net investment performance in the income statement as a component of income tax expense. Otherwise, the entity would apply either the equity method or the cost method, as appropriate.

Effective Date and Transition: The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. If adopted, the amendments should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The Company is currently evaluating the impact of this Update on its consolidated financial statements.

3. Accumulated other Comprehensive loss

Components of accumulated other comprehensive loss, net of tax consisted of the following (in thousands):

	3/31/2014	12/31/2013
Unrealized losses on available for sale securities	$ (381)	$ (751)
Unrecognized expense for defined benefit pension	(902)	(908)
Accumulated other comprehensive loss	$ (1,283)	$ (1,659)

4. Earnings Per Share

Basic earnings per share (EPS) is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company. Potential common shares that may be issued by the Company relate solely to outstanding stock options and are determined using the treasury stock method. The following table sets forth the computation of basic and diluted earnings per share:

(Amounts, except earnings per share, in thousands)

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Net income	$ 903	$ 1,006
Weighted-average common shares outstanding	4,196	4,218
Basic earnings per share	$ 0.22	$ 0.24
Weighted-average common shares outstanding	4,196	4,218
Common stock equivalents due to effect of stock options	1	1
Total weighted-average common shares and equivalents	4,197	4,219
Diluted earnings per share	$ 0.22	$ 0.24

5. Securities

The Company’s investment portfolio includes primarily bonds issued by U.S. Government sponsored agencies (approximately 66%) and municipalities (approximately 33%) as of March 31, 2014. Most of the municipal bonds are general obligation bonds with maturities or pre-refunding dates within 5 years. The remaining 1% of the portfolio includes mortgage-backed securities issued by Government-sponsored agencies and backed by residential mortgages and a group of equity investments in other financial institutions.

The amortized cost and fair value of securities as of March 31, 2014 and December 31, 2013, by contractual maturity, are shown below (in thousands). Expected maturities may differ from contractual maturities because the securities may be called or prepaid with or without prepayment penalties.

	March 31, 2014			
Securities Available for Sale			Gross	Gross
	Amortized	Fair	Unrealized	Unrealized
Type and maturity	Cost	Value	Gains	Losses
Obligations of Government agencies and corporations				
Within one year	$1,019	$1,027	$ 8	$ -
After one year but within five years	38,511	38,227	176	(460)
After five years but within ten years	31,612	30,828	7	(791)
	71,142	70,082	191	(1,251)
Obligations of state and political subdivisions				
Within one year	8,848	8,890	43	(1)
After one year but within five years	24,484	24,592	150	(42)
After five years but within ten years	7,207	7,239	79	(47)
After ten years	347	340	-	(7)
	40,886	41,061	272	(97)
Mortgage-backed securities	12,020	11,941	3	(82)
Equity securities	1,055	1,431	421	(45)
Total	$125,103	$124,515	$ 887	$ (1,475)

	December 31, 2013			
Securities Available for Sale			Gross	Gross
	Amortized	Fair	Unrealized	Unrealized
Type and maturity	Cost	Value	Gains	Losses
Obligations of Government agencies and corporations				
Within one year	$4,177	$4,192	$ 15	$ -
After one year but within five years	48,011	47,578	203	(636)
After five years but within ten years	27,615	26,508	-	(1,107)
	79,803	78,278	218	(1,743)
Obligations of state and political subdivisions				
Within one year	8,260	8,314	55	(1)
After one year but within five years	26,027	26,098	133	(62)
After five years but within ten years	7,224	7,182	56	(98)
After ten years	350	338	-	(12)
	41,861	41,932	244	(173)
Mortgage-backed securities	4,465	4,469	7	(3)
Equity securities	1,055	1,367	366	(54)
Total	$127,184	$126,046	$ 835	$ (1,973)

Certain obligations of the U.S. Government and state and political subdivisions are pledged to secure public deposits, securities sold under agreements to repurchase and for other purposes as required or permitted by law. The carrying value of the pledged assets was $27,301,000 and $31,921,000 at March 31, 2014 and December 31, 2013, respectively.

In addition to cash received from the scheduled maturities of securities, some investment securities available for sale are sold or called at current market values during the course of normal operations.

Following is a summary of proceeds received from sales or calls of investment securities transactions and the resulting realized gains and losses (in thousands):

	Three Months Ended March 31,	
	2014	2013
Gross proceeds from sales of securities	$ 2,150	$ -
Securities available for sale:		
Gross realized gains from sold and called securities	$ 5	$ 1
Gross realized losses from sold and called securities	-	-

Accounting Standards Codification (ASC) Topic 320, *Investments – Debt and Equity Securities*, clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are taken before an assessment is made as to whether the entity will recover the cost basis of the investment. For equity securities, consideration is given to management's intention and ability to hold the securities until recovery of unrealized losses in assessing potential other-than-temporary impairment. More specifically, factors considered to determine other-than-temporary impairment status for individual equity holdings include the length of time the stock has remained in an unrealized loss position, the percentage of unrealized loss compared to the carrying cost of the stock, dividend reduction or suspension, market analyst reviews and expectations, and other pertinent factors that would affect expectations for recovery or further decline.

In instances when a determination is made that an other-than-temporary impairment exists and the entity does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, the other-than-temporary impairment is separated into the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive (loss) income.

The following table shows gross unrealized losses and fair value, aggregated by category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2014 and December 31, 2013 (in thousands):

	Unrealized Losses at March 31, 2014					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of U.S. Government agencies and corporations	$50,951	$ (1,145)	$ 2,899	$ (106)	$53,850	$ (1,251)
Obligations of state and political subdivisions	9,229	(73)	2,177	(24)	11,406	(97)
Mortgage-backed securities	11,312	(82)	-	-	11,312	(82)
Debt securities	71,492	(1,300)	5,076	(130)	76,568	(1,430)
Equity securities	-	-	252	(45)	252	(45)
Total temporarily impaired securities	$71,492	$ (1,300)	$ 5,328	$ (175)	$76,820	$ (1,475)

	Unrealized Losses at December 31, 2013					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of U.S. Government agencies and corporations	$53,438	$ (1,664)	$ 1,921	$ (79)	$55,359	$ (1,743)
Obligations of state and political subdivisions	11,496	(130)	4,301	(43)	15,797	(173)
Mortgage-backed securities	308	(3)	-	-	308	(3)
Debt securities	65,242	(1,797)	6,222	(122)	71,464	(1,919)
Equity securities	-	-	266	(54)	266	(54)
Total temporarily impaired securities	$65,242	$ (1,797)	$ 6,488	$ (176)	$71,730	$ (1,973)

At March 31, 2014, 44 U.S. Government agency and corporations securities had unrealized losses that, in the aggregate, totaled 1.8% of amortized cost. Two of these securities have been in a continuous loss position for 12 months or more.

At March 21, 2014, 30 obligations of state and political subdivisions had unrealized losses that in the aggregate totaled 0.2% of amortized cost. Five of these securities have been in a continuous loss position for 12 months or more.

At March 31, 2014, six mortgage-backed securities had an unrealized loss that did not exceed 1% of amortized cost. None of these securities have been in a continuous loss position for 12 months or more.

The mortgage-backed securities in the Company's portfolio are government sponsored enterprise (GSE) pass-through instruments issued by the Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC), which guarantees the timely payment of principal on these investments.

The unrealized losses noted above are considered to be temporary impairments. The decline in the values of the debt securities is due only to interest rate fluctuations, rather than erosion of issuer credit quality. As a result, the payment of contractual cash flows, including principal repayment, is not at risk. As the Company does not intend to sell the securities, does not believe the Company will be required to sell the securities before recovery and expects to recover the entire amortized cost basis, none of the debt securities are deemed to be other-than-temporarily impaired.

Equity securities owned by the Company consist of common stock of various financial services providers and are evaluated quarterly for evidence of other-than-temporary impairment. There were five equity securities that were in an unrealized loss position on March 31, 2014, and have carried unrealized losses for 12 months or more. Individually, none of these five equity securities have significant unrealized losses. Of the five equity securities that have sustained unrealized losses for more than 12 months, all have increased in fair value in the preceding twelve months, and therefore are deemed to be temporarily impaired. Management has identified no other-than-temporary impairment as of, or for the periods ended March 31, 2014 and December 31, 2013 in the equity portfolio. Management continues to track the performance of each stock owned to determine if it is prudent to deem any further other-than-temporary impairment charges. The Company has the ability and intent to hold its equity securities until recovery of unrealized losses.

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6. Loans and Related Allowance for Credit Losses

Loans that the Company has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the outstanding unpaid principal balances, net of any deferred fees or costs and the allowance for loan losses. Interest income on all loans, other than nonaccrual loans, is accrued over the term of the loans based on the amount of principal outstanding. Unearned income is amortized to income over the life of the loans, using the interest method.

The loan portfolio is segmented into commercial and consumer loans. Commercial loans are comprised of the following classes of loans: (1) commercial, financial and agricultural, (2) commercial real estate, (3) real estate construction, a portion of (4) mortgage loans and (5) obligations of states and political subdivisions. Consumer loans are comprised of a portion of (4) mortgage loans and (6) personal loans.

Loans on which the accrual of interest has been discontinued are designated as non-accrual loans. Accrual of interest on loans is generally discontinued when the contractual payment of principal or interest has become 90 days past due or reasonable doubt exists as to the full, timely collection of principal or interest. However, it is the Company’s policy to continue to accrue interest on loans over 90 days past due as long as (1) they are guaranteed or well secured and (2) there is an effective means of timely collection in process. When a loan is placed on non-accrual status, all unpaid interest credited to income in the current year is reversed against current period income, and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans generally is either applied against principal or reported as interest income, according to management’s judgment as to the collectability of principal. Generally, accruals are resumed on loans only when the obligation is brought fully current with respect to interest and principal, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

The Company originates loans in the portfolio with the intent to hold them until maturity. At the time the Company no longer intends to hold loans to maturity based on asset/liability management practices, the Company transfers loans from its portfolio to held for sale at fair value. Any write-down recorded upon transfer is charged against the allowance for loan losses. Any write-downs recorded after the initial transfers are recorded as a charge to other non-interest expense. Gains or losses recognized upon sale are included in gains on sales of loans which is a component of non-interest income.

The Company also originates residential mortgage loans with the intent to sell. These individual loans are normally funded by the buyer immediately. The Company maintains servicing rights on these loans. Mortgage servicing rights are recognized as an asset upon the sale of a mortgage loan. A portion of the cost of the loan is allocated to the servicing right based upon relative fair value. Servicing rights are intangible assets and are carried at estimated fair value. Adjustments to fair value are recorded as non-interest income and included in gain on sales of loans in the consolidated statements of income.

The allowance for credit losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses (“allowance”) represents management’s estimate of losses inherent in the loan portfolio as of the consolidated statement of financial condition date and is recorded as a reduction to loans. The reserve for unfunded lending commitments represents management’s estimate of losses inherent in its unfunded lending commitments and is recorded in other liabilities on the consolidated statement of financial condition, when necessary. The amount of the reserve for unfunded lending commitments is not material to the consolidated financial statements. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

For financial reporting purposes, the provision for loan losses charged to current operating income is based on management's estimates, and actual losses may vary from estimates. These estimates are reviewed and adjusted at least quarterly and are reported in earnings in the periods in which they become known.

Loans included in any class are considered for charge-off when:

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- principal or interest has been in default for 120 days or more and for which no payment has been received during the previous four months;
- all collateral securing the loan has been liquidated and a deficiency balance remains;
- a bankruptcy notice is received for an unsecured loan;
- a confirming loss event has occurred; or
- the loan is deemed to be uncollectible for any other reason.

The allowance for loan losses is maintained at a level considered adequate to offset probable losses on the Company's existing loans. The analysis of the allowance for loan losses relies heavily on changes in observable trends that may indicate potential credit weaknesses. Management's periodic evaluation of the adequacy of the allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses and may require the Company to recognize additions to the allowance for loan losses based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the level of the allowance for loan losses as of March 31, 2014 was adequate.

There are two components of the allowance: a specific component for loans that are deemed to be impaired; and a general component for contingencies.

A loan is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loans and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent.

The estimated fair values of substantially all of the Company's impaired loans are measured based on the estimated fair value of the loan's collateral. For commercial loans secured with real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the current appraisal and the condition of the property. Appraised values may be discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include the estimated costs to sell the property. For commercial loans secured by non-real estate collateral, estimated fair values are determined based on the borrower's financial statements, inventory reports, aging accounts receivable, equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The Company generally does not separately identify individual consumer segment loans for impairment disclosures, unless such loans are subject to a restructuring agreement.

Loans whose terms are modified are classified as troubled debt restructurings if the Company grants borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a below-market interest rate based on the loan's risk characteristics or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for a sustained period of time after modification. Loans classified as troubled debt restructurings are designated as impaired.

The component of the allowance for contingencies relates to other loans that have been segmented into risk rated categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated quarterly or when credit deficiencies arise, such as delinquent loan payments. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans classified as special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified as substandard have one or more well-defined weaknesses that jeopardize the liquidation of the debt. Substandard loans include loans that are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass. Specific reserves may be established for larger, individual classified loans as a result of this evaluation, as discussed above. Remaining loans are categorized into large groups of smaller balance homogeneous loans and are collectively evaluated for impairment. This computation is generally based on historical loss experience adjusted for qualitative factors. The historical loss experience is averaged over a ten-year period for each of the portfolio segments. The ten-year timeframe was selected in order to capture activity over a wide range of economic conditions and has been consistently used by the Company for the past seven years. Qualitative risk factors are reviewed for relevancy each quarter and include:

- National, regional and local economic and business conditions, as well as the condition of various market segments, including the underlying collateral for collateral dependent loans;
- Nature and volume of the portfolio and terms of loans;
- Experience, ability and depth of lending and credit management and staff;
- Volume and severity of past due, classified and nonaccrual loans, as well as other loan modifications;
- Existence and effect of any concentrations of credit and changes in the level of such concentrations; and
- Effect of external factors, including competition.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

Commercial, Financial and Agricultural Lending

The Company originates commercial, financial and agricultural loans primarily to businesses located in its primary market area and surrounding areas. These loans are used for various business purposes, which include short-term loans and lines of credit to finance machinery and equipment purchases, inventory and accounts receivable. Generally, the maximum term for loans extended on machinery and equipment is shorter and does not exceed the projected useful life of such machinery and equipment. Most business lines of credit are written with a five year maturity, subject to an annual credit review.

Commercial loans are generally secured with short-term assets; however, in many cases, additional collateral, such as real estate, is provided as additional security for the loan. Loan-to-value maximum values have been established by the Company and are specific to the type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, collateral appraisals, etc.

In underwriting commercial loans, an analysis of the borrower’s character, capacity to repay the loan, the adequacy of the borrower’s capital and collateral, as well as an evaluation of conditions affecting the borrower, is performed. Analysis of the borrower’s past, present and future cash flows is also an important aspect of the Company’s analysis.

Concentration analysis assists in identifying industry specific risk inherent in commercial, financial and agricultural lending. Mitigants include the identification of secondary and tertiary sources of repayment and appropriate increases in oversight.

Commercial, financial and agricultural loans generally present a higher level of risk than certain other types of loans, particularly during slow economic conditions.

Commercial Real Estate Lending

The Company engages in commercial real estate lending in its primary market area and surrounding areas. The Company's commercial real estate portfolio is secured primarily by residential housing, commercial buildings, raw land and hotels. Generally, commercial real estate loans have terms that do not exceed 20 years, have loan-to-value ratios of up to 80% of the appraised value of the property and are typically secured by personal guarantees of the borrowers.

As economic conditions deteriorate, the Company reduces its exposure in real estate loans with higher risk characteristics. In underwriting these loans, the Company performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the property securing the loan. Appraisals on properties securing commercial real estate loans originated by the Company are performed by independent appraisers.

Commercial real estate loans generally present a higher level of risk than certain other types of loans, particularly during slow economic conditions.

Real Estate Construction Lending

The Company engages in real estate construction lending in its primary market area and surrounding areas. The Company's real estate construction lending consists of commercial and residential site development loans, as well as commercial building construction and residential housing construction loans.

The Company's commercial real estate construction loans are generally secured with the subject property, and advances are made in conformity with a pre-determined draw schedule supported by independent inspections. Terms of construction loans depend on the specifics of the project, such as estimated absorption rates, estimated time to complete, etc.

In underwriting commercial real estate construction loans, the Company performs a thorough analysis of the financial condition of the borrower, the borrower’s credit history, the reliability and predictability of the cash flow generated by the project using feasibility studies, market data, etc. Appraisals on properties securing commercial real estate loans originated by the Company are performed by independent appraisers.

Real estate construction loans generally present a higher level of risk than certain other types of loans, particularly during slow economic conditions. The difficulty of estimating total construction costs adds to the risk as well.

Mortgage Lending

The Company’s real estate mortgage portfolio is comprised of consumer residential mortgages and business loans secured by one-to-four family properties. One-to-four family residential mortgage loan originations, including home equity installment and home equity lines of credit loans, are generated by the Company’s marketing efforts, its present customers, walk-in customers and referrals. These loans originate primarily within the Company’s market area or with customers primarily from the market area.

The Company offers fixed-rate and adjustable rate mortgage loans with terms up to a maximum of 25-years for both permanent structures and those under construction. The Company’s one-to-four family residential mortgage originations are secured primarily by properties located in its primary market area and surrounding areas. The majority of the Company’s residential mortgage loans originate with a loan-to-value of 80% or less. Home equity installment loans are secured by the borrower’s primary residence with a maximum loan-to-value of 80% and a maximum term of 15 years. Home equity lines of credit are secured by the borrower’s primary residence with a maximum loan-to-value of 90% and a maximum term of 20 years.

In underwriting one-to-four family residential real estate loans, the Company evaluates the borrower's ability to make monthly payments, the borrower's repayment history and the value of the property securing the loan. The ability to repay is determined by the borrower's employment history, current financial conditions, and credit background. The analysis is based primarily on the customer's ability to repay and secondarily on the collateral or security. Most properties securing real estate loans made by the Company are appraised by independent fee appraisers. The Company generally requires mortgage loan borrowers to obtain an attorney's title opinion or title insurance, and fire and property insurance (including flood insurance, if necessary) in an amount not less than the amount of the loan. The Company does not engage in sub-prime residential mortgage originations.

Residential mortgage loans and home equity loans generally present a lower level of risk than certain other types of consumer loans because they are secured by the borrower's primary residence. Risk is increased when the Company is in a subordinate position for the loan collateral.

Obligations of States and Political Subdivisions

The Company lends to local municipalities and other tax-exempt organizations. These loans are primarily tax-anticipation notes and, as such, carry little risk. Historically, the Company has never had a loss on any loan of this type.

Personal Lending

The Company offers a variety of secured and unsecured personal loans, including vehicle loans, mobile home loans and loans secured by savings deposits as well as other types of personal loans.

Personal loan terms vary according to the type and value of collateral and creditworthiness of the borrower. In underwriting personal loans, a thorough analysis of the borrower's willingness and financial ability to repay the loan as agreed is performed. The ability to repay is determined by the borrower's employment history, current financial conditions and credit background.

Personal loans may entail greater credit risk than do residential mortgage loans, particularly in the case of personal loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles or recreational equipment. In such cases, any repossessed collateral for a defaulted personal loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, personal loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system as of March 31, 2014 and December 31, 2013 (in thousands):

As of March 31, 2014	Pass	Special Mention	Substandard	Doubtful	Total
Commercial, financial and agricultural	$24,032	$1,486	$ 259	$ -	$25,777
Real estate - commercial	60,722	11,172	4,355	1,575	77,824
Real estate - construction	13,184	449	2,437	529	16,599
Real estate - mortgage	126,705	5,569	4,453	1,600	138,327
Obligations of states and political subdivisions	13,352	26	-	-	13,378
Personal	3,974	104	-	-	4,078
Total	$241,969	$18,806	$ 11,504	$ 3,704	$275,983

As of December 31, 2013	Pass	Special Mention	Substandard	Doubtful	Total
Commercial, financial and agricultural	$20,388	$5,658	$ 235	$ -	$26,281
Real estate - commercial	56,867	11,706	5,620	278	74,471
Real estate - construction	15,803	292	1,754	1,832	19,681
Real estate - mortgage	130,706	3,995	4,272	1,486	140,459
Obligations of states and political subdivisions	12,674	28		-	12,702
Personal	4,204	-		-	4,204
Total	$240,642	$21,679	$ 11,881	$ 3,596	$277,798

The Company has certain loans in its portfolio that are considered to be impaired. It is the policy of the Company to recognize income on impaired loans that have been transferred to nonaccrual status on a cash basis, only to the extent that it exceeds principal balance recovery. Until an impaired loan is placed on nonaccrual status, income is recognized on the accrual basis. Collateral analysis is performed on each impaired loan at least quarterly and results are used to determine if a specific reserve is necessary to adjust the carrying value of each individual loan down to the estimated fair value. Generally, specific reserves are carried against impaired loans based upon estimated collateral value until a confirming loss event occurs or until termination of the credit is scheduled through liquidation of the collateral or foreclosure. Charge off will occur when a confirmed loss is identified. Professional appraisals of collateral, discounted for expected selling costs, appraisal age, economic conditions and other known factors are used to determine the charge-off amount. The following tables summarize information regarding impaired loans by portfolio class as of March 31, 2014 and December 31, 2013 (in thousands):

	As of March 31, 2014			As of December 31, 2013		
Impaired loans	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial, financial and agricultural	$7	$ 7	$ -	$94	$ 94	$ -
Real estate - commercial	835	873	-	2,017	2,142	-
Real estate - construction	1	64	-	504	813	-
Real estate - mortgage	3,570	4,968	-	3,353	4,751	-
With an allowance recorded:						
Real estate - commercial	$1,999	$ 1,999	$ 87	$238	$ 238	$ 26
Real estate - construction	528	803	64	1,478	1,502	93
Real estate - mortgage	358	392	46	365	394	45
Total:						
Commercial, financial and agricultural	$7	$ 7	$ -	$94	$ 94	$ -
Real estate - commercial	2,834	2,872	87	2,255	2,380	26
Real estate - construction	529	867	64	1,982	2,315	93
Real estate - mortgage	3,928	5,360	46	3,718	5,145	45
	$7,298	$ 9,106	$ 197	$8,049	$ 9,934	$ 164

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Impaired loans	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Income	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Income
With no related allowance recorded:						
Commercial, financial and agricultural	$ 51	$ 11	$ -	$ 153	$ 3	$ -
Real estate - commercial	1,426	-	3	2,629	27	-
Real estate - construction	253	-	-	1,651	-	&nb