NORTHEAST BANCORP /ME/
Form 10-Q
November 14, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2013

Commission File Number: 1-14588

Northeast Bancorp

(Exact name of registrant as specified in its charter)

Maine	**01-0425066**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
500 Canal Street, Lewiston, Maine	**04240**
(Address of Principal executive offices)	(Zip Code)

(207) 786-3245

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 subjected to such filing requirements for the past 90 days. Yes x No o

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

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 definition of accelerated filer , large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (check one): Large accelerated filer o Accelerated filer o Non-accelerated filer o Smaller Reporting Company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. As of October 31, 2013, the registrant had outstanding 9,552,587 shares of voting common stock, $1.00 par value per share and 880,963 shares of non-voting common stock, $1.00 par value per share.

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PART 1- FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Unaudited)

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

	September 30, 2013	June 30, 2013
Assets		
Cash and due from banks	$ 2,849	$ 3,238
Short-term investments	74,502	62,696
Total cash and cash equivalents	77,351	65,934
Available-for-sale securities, at fair value	118,207	121,597
Loans held for sale	5,418	8,594
Loans	483,486	435,376
Less: Allowance for loan losses	1,224	1,143
Loans, net	482,262	434,233
Premises and equipment, net	9,827	10,075
Real estate owned and other repossessed collateral, net	3,413	2,134
Federal Home Loan Bank and Federal Reserve Bank stock, at cost	5,721	5,721
Intangible assets, net	3,334	3,544
Bank owned life insurance	14,502	14,385
Other assets	4,920	4,422
Total assets	$ 724,955	$ 670,639
Liabilities and Stockholders Equity		
Deposits		
Demand	$ 50,392	$ 46,425
Savings and interest checking	91,330	90,970
Money market	85,855	84,416
Time	304,521	262,812
Total deposits	532,098	484,623
Federal Home Loan Bank advances	42,985	28,040
Wholesale repurchase agreements	15,343	25,397
Short-term borrowings	1,970	625
Junior subordinated debentures issued to affiliated trusts	8,310	8,268
Capital lease obligation	1,695	1,739
Other liabilities	8,708	8,145
Total liabilities	611,109	556,837

Commitments and contingencies				
Stockholders equity				
Preferred stock, $1.00 par value, 1,000,000 shares authorized; no shares issued and outstanding at September 30, 2013 and June 30, 2013				
Voting common stock, $1.00 par value, 25,000,000 shares authorized; 9,552,587 and 9,565,680 shares issued and outstanding at September 30, 2013 and June 30, 2013, respectively		9,553		9,566
Non-voting common stock, $1.00 par value, 3,000,000 shares authorized; 880,963 shares issued and outstanding at September 30, 2013 and June 30, 2013		881		881
Additional paid-in capital		93,081		92,745
Retained earnings		11,904		12,524
Accumulated other comprehensive loss		(1,573)		(1,914)
Total stockholders equity		113,846		113,802
Total liabilities and stockholders equity	$	724,955	$	670,639

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

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

	Three Months Ended September 30, 2013	2012
Interest income:		
Loans	$ 8,457	$ 7,341
Available-for-sale securities	282	347
Other	52	89
Total interest income	8,791	7,777
Interest expense:		
Deposits	1,047	978
Federal Home Loan Bank advances	323	259
Wholesale repurchase agreements	95	219
Short-term borrowings	5	6
Junior subordinated debentures issued to affiliated trusts	192	193
Obligation under capital lease agreements	22	24
Total interest expense	1,684	1,679
Net interest income before provision for loan losses	7,107	6,098
Provision for loan losses	77	228
Net interest income after provision for loan losses	7,030	5,870
Noninterest income:		
Fees for other services to customers	439	310
Net securities gains		792
Gain on sales of loans held for sale	539	756
Gain on sales of portfolio loans	216	
(Loss) gain recognized on real estate owned and other repossessed collateral, net	(38)	451
Investment commissions	675	675
Bank-owned life insurance income	118	123
Other noninterest income	14	43
Total noninterest income	1,963	3,150
Noninterest expense:		
Salaries and employee benefits	5,144	4,057
Occupancy and equipment expense	1,355	1,078
Professional fees	426	423
Data processing fees	314	268
Marketing expense	44	187
Loan acquisition and collection expense	473	454
FDIC insurance premiums	110	117
Intangible asset amortization	210	265
Legal settlement recovery	(250)	
Other noninterest expense	686	653
Total noninterest expense	8,512	7,502
Income before income tax expense	481	1,518
Income tax expense	161	484

Net income	$	320	$	1,034
Net income available to common stockholders	$	320	$	936
Weighted-average shares outstanding:				
Basic		10,440,513		10,383,441
Diluted		10,440,513		10,383,441
Earnings per common share:				
Basic	$	0.03	$	0.09
Diluted	$	0.03	$	0.09
Cash dividends declared per common share	$	0.09	$	0.09

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Dollars in thousands)

	Three Months Ended September 30, 2013	2012
Net income	$ 320	$ 1,034
Other comprehensive income (loss), before tax:		
Available-for-sale securities:		
Change in net unrealized gain or loss on available-for-sale securities	517	157
Reclassification adjustment for net gains included in net income		(792)
Total available-for-sale securities	517	(635)
Derivatives and hedging activities:		
Change in accumulated loss on effective cash flow hedges	19	6
Reclassification adjustments for net gains included in net income	(19)	(18)
Total derivatives and hedging activities		(12)
Total other comprehensive income (loss), before tax	517	(647)
Income tax expense (benefit) related to other comprehensive (loss) income	176	(220)
Other comprehensive income (loss), net of tax	341	(427)
Total comprehensive income	$ 661	$ 607

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(Unaudited)

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

	Preferred Stock		Voting Common Stock		Non-voting Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
	Shares	Amount	Shares	Amount	Shares	Amount				
Balance at June 30, 2012	4,227	$ 4	9,307,127	$ 9,307	1,076,314	$ 1,076	$ 96,359	$ 12,235	$ 158	$ 119,135
Net income								1,034		1,034
Other comprehensive loss, net of tax									(427)	(427)
Conversion of non-voting common stock to voting common stock			105,845	106	(105,845)	(106)				
Dividends on preferred stock								(53)		(53)
Dividends on common stock at $0.09 per share								(935)		(935)
Stock-based compensation							99			99
Accretion of preferred stock							45	(45)		
Balance at September 30, 2012	4,227	$ 4	9,412,972	$ 9,413	970,469	$ 970	$ 96,503	$ 12,236	$ (269)	$ 118,853
Balance at June 30, 2013		$	9,565,680	$ 9,566	880,963	$ 881	$ 92,745	$ 12,524	$ (1,914)	$ 113,802
Net income								320		320
Other comprehensive income, net of tax									341	341
Dividends on common stock at $0.09 per share								(940)		(940)
Stock-based compensation							323			323
Forfeiture of restricted common stock			(13,093)	(13)			13			
Balance at September 30, 2013		$	9,552,587	$ 9,553	880,963	$ 881	$ 93,081	$ 11,904	$ (1,573)	$ 113,846

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Dollars in thousands)

	Three Months Ended September 30, 2013	2012
Operating activities:		
Net income	$ 320	$ 1,034
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	77	228
Loss (gain) on sale and impairment of real estate owned, net	102	(451)
Accretion of fair value adjustments on loans, net	(1,317)	(1,692)
Accretion of fair value adjustments on deposits, net	(201)	(275)
Accretion of fair value adjustments on borrowings, net	(67)	(441)
Originations of loans held for sale	(27,433)	(38,204)
Net proceeds from sales of loans held for sale	31,148	35,856
Gain on sales of loans held for sale	(539)	(756)
Gain on sales of portfolio loans	(216)	
Amortization of intangible assets	210	265
Bank-owned life insurance income, net	(118)	(123)
Depreciation of premises and equipment	522	424
Gain on sale of premises and equipment	(1)	
Net gain on sale of available-for-sale securities		(792)
Stock-based compensation	323	99
Amortization of securities, net	335	420
Changes in other assets and liabilities:		
Other assets	(497)	349
Other liabilities	387	(177)
Net cash provided by (used in) operating activities	3,035	(4,236)
Investing activities:		
Proceeds from sales of available-for-sale securities		159,579
Purchases of available-for-sale securities	(3,004)	(167,294)
Proceeds from maturities and principal payments on available-for-sale securities	6,576	3,647
Loan purchases	(16,348)	(31,023)
Loan originations and principal collections, net	(31,961)	11,437
Purchases of premises and equipment	(284)	(514)
Proceeds from sales of premises and equipment	11	
Proceeds from sales of real estate owned and other repossessed collateral	150	595
Proceeds from sales of portfolio loans	205	
Net cash used in investing activities	(44,655)	(23,573)
Financing activities:		
Net increase in deposits	47,676	33,862
Net decrease in short-term borrowings	1,345	(725)
Dividends paid on preferred stock		(53)
Dividends paid on common stock	(940)	(935)
Proceeds from FHLB advances	15,000	
Repayment of wholesale repurchase agreements	(10,000)	(30,000)

Repayment of capital lease obligation		(44)		(42)
Net cash provided by financing activities		53,037		2,107
Net increase (decrease) in cash and cash equivalents		11,417		(25,702)
Cash and cash equivalents, beginning of period		65,934		128,274
Cash and cash equivalents, end of period	$	77,351	$	102,572
Supplemental schedule of noncash investing and financing activities:				
Transfers from loans to real estate owned and other repossessed collateral	$	1,531	$	3,010
Transfers from real estate owned and other repossessed collateral to loans				1,055

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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NORTHEAST BANCORP AND SUBSIDIARY

Notes to Unaudited Consolidated Financial Statements

September 30, 2013

1. Basis of Presentation

The accompanying unaudited condensed and consolidated interim financial statements include the accounts of Northeast Bancorp (Northeast or the Company) and its wholly-owned subsidiary, Northeast Bank (the Bank).

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting principally of normal recurring accruals) considered necessary for a fair presentation of the Company s financial position, results of operations, and cash flows for the interim periods presented. These financial statements and notes should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2013 (Fiscal 2013) included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission.

2. Recent Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* (ASU 2011-11). The update requires entities to disclose information about offsetting and related arrangements of financial instruments and derivative instruments. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (i) offset in accordance with current literature or (ii) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with current literature. ASU 2011-11 is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The adoption of this guidance did not have a material impact on the consolidated financial statements.

In January 2013, the FASB issued ASU No. 2013-01, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* (ASU 2013-01). The amendments clarify that the scope of Update 2011-11 applies to derivatives accounted for in accordance with Topic 815, *Derivatives and Hedging*, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The new standards are effective for annual periods beginning January 1, 2013 and for interim periods within those annual periods. Retrospective application is required. The adoption of this guidance did not have a material impact on the consolidated financial statements.

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3. Securities Available-for-Sale

Securities available-for-sale at amortized cost and fair values are summarized below.

	September 30, 2013				June 30, 2013			
	Amortized Cost		Fair Value		Amortized Cost		Fair Value	
	(Dollars in thousands)							
U.S. Government agency securities	$	45,181	$	45,223	$	45,289	$	45,333
Agency mortgage-backed securities		75,146		72,984		78,944		76,264
	$	120,327	$	118,207	$	124,233	$	121,597

The gross unrealized gains and unrealized losses on available-for-sale securities follow.

	September 30, 2013				June 30, 2013			
	Gross Unrealized Gains		Gross Unrealized Losses		Gross Unrealized Gains		Gross Unrealized Losses	
	(Dollars in thousands)							
U.S. Government agency securities	$	42	$		$	44	$	
Agency mortgage-backed securities				(2,162)				(2,680)
	$	42	$	(2,162)	$	44	$	(2,680)

When securities are sold, the adjusted cost of the specific security sold is used to compute the gain or loss on sale. The following table summarizes realized gains and losses on available-for-sale securities.

	Three Months Ended September 30,			
	2013		2012	
	(Dollars in thousands)			
Gross realized gains	$		$	831
Gross realized losses				(39)
Net security gains	$		$	792

At September 30, 2013, investment securities with a fair value of approximately $42.9 million were pledged as collateral to secure outstanding borrowings.

The following summarizes the Company s gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

	September 30, 2013					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
U.S. Government agency securities	$	$	$	$	$	$
Agency mortgage-backed securities	69,719	(2,155)	3,265	(7)	72,984	(2,162)
	$ 69,719	$ (2,155)	$ 3,265	$ (7)	$ 72,984	$ (2,162)

	June 30, 2013					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
U.S. Government agency securities	$	$	$	$	$	$
Agency mortgage-backed securities	76,264	(2,680)			76,264	(2,680)
	$ 76,264	$ (2,680)	$	$	$ 76,264	$ (2,680)

There were no other-than-temporary impairment losses on securities during the three months ended September 30, 2013 or 2012.

At September 30, 2013, the Company had one security in a continuous loss position for greater than twelve months. At September 30, 2013, all of the Company s available-for-sale securities were issued or guaranteed by either government agencies or government-sponsored enterprises. The decline in fair value of the Company s available-for-sale securities at September 30, 2013 is attributable to changes in interest rates.

Management of the Company, in addition to considering current trends and economic conditions that may affect the quality of individual securities within the Company s investment portfolio, also considers the Company s ability and intent to hold such securities to maturity or recovery of cost. Management does not believe any of the Company s available-for-sale securities are other-than-temporarily impaired at September 30, 2013.

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The amortized cost and fair values of available-for-sale debt securities by contractual maturity are shown below as of September 30, 2013. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
	(Dollars in thousands)	
Due within one year	$ 42,176	$ 42,217
Due after one year through five years	3,004	3,005
Due after five years through ten years	39,441	38,715
Due after ten years	35,706	34,270
	$ 120,327	$ 118,207

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4. Loans, Allowance for Loan Losses and Credit Quality

Loans are carried at the principal amounts outstanding, or amortized acquired fair value in the case of acquired loans, adjusted by partial charge-offs and net of deferred loan costs or fees. Loan fees and certain direct origination costs are deferred and amortized into interest income over the expected term of the loan using the level-yield method. When a loan is paid off, the unamortized portion is recognized in interest income. Interest income is accrued based upon the daily principal amount outstanding except for loans on nonaccrual status.

All loans purchased by the Company in the secondary market by the Bank s Loan Acquisition and Servicing Group (LASG) are accounted for under ASC 310-30, *Receivables Loans and Debt Securities Acquired with Deteriorated Credit Quality* (ASC 310-30). At acquisition, the effective interest rate is determined based on the discount rate that equates the present value of the Company s estimate of cash flows with the purchase price of the loan. Prepayments are not assumed in determining a purchased loan s effective interest rate and income accretion. The application of ASC 310-30 limits the yield that may be accreted on the purchased loan, or the accretable yield, to the excess of the Company s estimate, at acquisition, of the expected undiscounted principal, interest, and other cash flows over the Company s initial investment in the loan. The excess of contractually required payments receivable over the cash flows expected to be collected on the loan represents the purchased loan s nonaccretable difference. Subsequent improvements in expected cash flows of loans with nonaccretable differences result in a prospective increase to the loan s effective yield through a reclassification of some, or all, of the nonaccretable difference to accretable yield. The effect of subsequent declines in expected cash flows of purchased loans are recorded through a specific allocation in the allowance for loan losses.

Loans are generally placed on nonaccrual status when they are past due 90 days as to either principal or interest, or when in management s judgment the collectability of interest or principal of the loan has been significantly impaired. Loans accounted for under ASC 310-30 are placed on nonaccrual when it is not possible to reach a reasonable expectation of the timing and amount of cash flows to be collected on the loan. When a loan has been placed on nonaccrual status, previously accrued and uncollected interest is reversed against interest on loans. Interest on nonaccrual loans is accounted for on a cash-basis or using the cost-recovery method when collectability is doubtful. A loan is returned to accrual status when collectability of principal is reasonably assured and the loan has performed for a reasonable period of time.

In cases where a borrower experiences financial difficulties and the Company makes certain concessionary modifications to contractual terms, the loan is classified as a troubled debt restructuring (TDR). Concessionary modifications may include adjustments to interest rates, extensions of maturity, and other actions intended to minimize economic loss and avoid foreclosure or repossession of collateral. For loans accounted for under ASC 310-30, the Company evaluates whether it has granted a concession by comparing the restructured debt terms to the expected cash flows at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition. As a result, if an ASC 310-30 loan is modified to be consistent with, or better than, the Company s expectations at acquisition, the loan would not qualify as a TDR. Nonaccrual loans that are restructured generally remain on nonaccrual status for a minimum period of six months to demonstrate that the borrower can meet the restructured terms. If the restructured loan is on accrual status prior to being modified, it is reviewed to determine if the modified loan should remain on accrual status. If the borrower s ability to meet the revised payment schedule is not reasonably assured, the loan is classified as a nonaccrual loan. With limited exceptions, loans classified as TDRs remain classified as such until the loan is paid off.

The composition of the Company s loan portfolio follows.

	September 30, 2013			June 30, 2013		
	Originated	Purchased	Total	Originated	Purchased	Total
			(Dollars in thousands)			
Residential real estate	$ 110,720	$ 2,645	$ 113,365	$ 89,734	$ 2,706	$ 92,440

Home equity		33,255				33,255		35,389				35,389
Commercial real estate		109,326		174,746		284,072		100,402		164,046		264,448
Construction		42				42		42				42
Commercial business		40,220		21		40,241		29,686		34		29,720
Consumer		12,511				12,511		13,337				13,337
Total loans	$	306,074	$	177,412	$	483,486	$	268,590	$	166,786	$	435,376

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Allowance for Loan Losses and Impaired Loans

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. For residential and consumer loans, a charge-off is recorded no later than the point at which a loan is 180 days past due if the loan balance exceeds the fair value of the collateral, less costs to sell. For commercial loans, a charge-off is recorded on a case-by-case basis when all or a portion of the loan is deemed to be uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses consists of general, specific, and unallocated reserves and reflects management s estimate of probable loan losses inherent in the loan portfolio at the balance sheet date. Management uses a consistent and systematic process and methodology to evaluate the adequacy of the allowance for loan losses on a quarterly basis. The calculation of the allowance for loan losses is segregated by portfolio segments, which include: commercial real estate, commercial business, consumer, residential real estate, and purchased loans. Risk characteristics relevant to each portfolio segment are as follows:

Residential real estate: All loans in this segment are collateralized by residential real estate and repayment is primarily dependent on the credit quality of the individual borrower. The overall health of the economy, particularly unemployment rates and housing prices, has a significant effect on the credit quality in this segment. For purposes of the Company s allowance for loan loss calculation, home equity loans and lines of credit are included in residential real estate.

Commercial real estate: Loans in this segment are primarily income-producing properties. For owner-occupied properties, the cash flows are derived from an operating business, and the underlying cash flows may be adversely affected by deterioration in the financial condition of the operating business. The underlying cash flows generated by non-owner occupied properties may be adversely affected by increased vacancy rates. Management periodically obtains rent rolls, with which it monitors the cash flows of these loans. Adverse developments in either of these areas will have an adverse effect on the credit quality of this segment. For purposes of the allowance for loan losses, this segment also includes construction loans.

Commercial business: Loans in this segment are made to businesses and are generally secured by the assets of the business. Repayment is expected from the cash flows of the business. Continued weakness in national or regional economic conditions, and a corresponding weakness in consumer or business spending, will have an adverse effect on the credit quality of this segment.

Consumer: Loans in this segment are generally secured, and repayment is dependent on the credit quality of the individual borrower. Repayment of consumer loans is generally based on the earnings of individual borrowers, which may be adversely impacted by regional labor market conditions.

Purchased: Loans in this segment are secured by commercial real estate, multi-family residential real estate, or business assets and have been acquired by the LASG. Loans acquired by the LASG are, with limited exceptions, performing loans at the date of purchase. Loans in this segment acquired with specific material credit deterioration since origination are identified as purchased credit-impaired. Repayment of loans in this segment is largely dependent on cash flow from the successful operation of the property, in the case of non-owner occupied property, or operating business, in the case of owner-occupied property. Loan performance may be adversely affected by factors affecting the general economy or conditions specific to the real estate market, such as geographic location or property type. Loans in this segment are evaluated for impairment under ASC 310-30. The Company reviews expected cash flows from purchased loans on a quarterly basis. The effect of a decline in expected cash flows subsequent to the acquisition of the loan is recognized through a specific allocation in the allowance for loan losses.

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by loan segment. The Company does not weight periods used in that analysis to determine the average loss rate in each portfolio segment. This historical loss factor is adjusted for the following qualitative factors:

- Levels and trends in delinquencies
- Trends in the volume and nature of loans
- Trends in credit terms and policies, including underwriting standards, procedures and practices, and the experience and ability of lending management and staff
- Trends in portfolio concentration
- National and local economic trends and conditions.
- Effects of changes or trends in internal risk ratings
- Other effects resulting from trends in the valuation of underlying collateral

There were no significant changes in the Company s policies or methodology pertaining to the general component of the allowance for loan losses during the three months ended September 30, 2013 or 2012.

The allocated component of the allowance for loan losses relates to loans that are classified as impaired. Impairment is measured on a loan-by-loan basis for commercial business and commercial real estate loans by either the present value of expected future cash flows discounted at the loan s effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of that loan. Large groups of smaller-balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for

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impairment based on the group s historical loss experience adjusted for qualitative factors. Accordingly, the Company does not separately identify individual consumer and residential loans for individual impairment and disclosure. However, all loans modified in troubled debt restructurings are individually reviewed for impairment.

For all portfolio segments, except the purchased loan segment, a loan is considered 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. 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 loan 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. For the purchased loan segment, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to realize cash flows as estimated at acquisition. Loan impairment of purchased loans is measured based on the decrease in expected cash flows from those estimated at acquisition, excluding changes due to changes in interest rate indices and other non-credit related factors, discounted at the loan s effective rate assumed at acquisition. Factors considered by management in determining impairment include payment status, collateral value, and the probability of the collecting scheduled principal and interest payments when due.

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The following table sets forth activity in the Company s allowance for loan losses.

	Three Months Ended September 30, 2013						
	Residential Real Estate	Commercial Real Estate	Commercial Business	Consumer (Dollars in thousands)	Purchased	Unallocated	Total
Beginning balance	$ 594	$ 173	$ 70	$ 189	$ 76	$ 41	$ 1,143
Provision	115	(10)	(26)	(53)	25	26	77
Recoveries	6		6	18			30
Charge-offs	(20)			(6)			(26)
Ending balance	$ 695	$ 163	$ 50	$ 148	$ 101	$ 67	$ 1,224

	Three Months Ended September 30, 2012						
	Residential Real Estate	Commercial Real Estate	Commercial Business	Consumer (Dollars in thousands)	Purchased	Unallocated	Total
Beginning balance	$ 214	$ 93	$ 292	$ 225	$	$	$ 824
Provision	213	(22)	(36)	73			228
Recoveries	1			3			4
Charge-offs	(127)		(203)	(58)			(388)
Ending balance	$ 301	$ 71	$ 53	$ 243	$	$	668

The following table sets forth information regarding the allowance for loan losses by portfolio segment and impairment methodology.

	September 30, 2013						
	Residential Real Estate	Commercial Real Estate	Commercial Business	Consumer (Dollars in thousands)	Purchased	Unallocated	Total
Allowance for loan losses:							
Individually evaluated	$ 190	$ 81	$ 44	$ 11	$ 65	$	$ 391
Collectively evaluated	505	82	6	137		67	797
ASC 310-30					36		36
Total	$ 695	$ 163	$ 50	$ 148	$ 101	$ 67	$ 1,224
Loans:							
Individually evaluated	$ 2,281	$ 1,561	$ 123	$ 201	$ 2,544	$	$ 6,710
Collectively evaluated	141,694	107,807	40,097	12,310			301,908
ASC 310-30					174,868		174,868
Total	$ 143,975	$ 109,368	$ 40,220	$ 12,511	$ 177,412	$	$ 483,486

	June 30, 2013						
	Residential Real Estate	Commercial Real Estate	Commercial Business	Consumer	Purchased	Unallocated	Total

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