UNION BANKSHARES INC
Form 10-Q
August 14, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: June 30, 2014

Commission file number: 001-15985

UNION BANKSHARES, INC.

VERMONT	03-0283552

P.O. BOX 667
20 LOWER MAIN STREET
MORRISVILLE, VT 05661

Registrant's telephone number: 802-888-6600

Former name, former address and former fiscal year, if changed since last report: Not applicable

Securities registered pursuant to section 12(b) of the Act:

Common Stock, $2.00 par value	Nasdaq Stock Market
(Title of class)	(Exchanges registered on)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate 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 [ ]

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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ]	Accelerated filer [ ]
Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).
Yes [ ] No [X]

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of August 1, 2014:

Common Stock, $2 par value	4,458,517 shares

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PART I FINANCIAL INFORMATION
Item 1. Financial Statements
UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

	June 30, 2014 (Unaudited)	December 31, 2013
Assets	(Dollars in thousands)	
Cash and due from banks	$4,154	$5,223
Federal funds sold and overnight deposits	15,490	25,496
Cash and cash equivalents	19,644	30,719
Interest bearing deposits in banks	13,713	17,613
Investment securities available-for-sale	40,359	34,281
Investment securities held-to-maturity (fair value $9.3 million and $10.4 million at June 30, 2014 and December 31, 2013, respectively)	9,642	11,211
Loans held for sale	6,662	3,840
Loans	455,345	461,113
Allowance for loan losses	(4,610)	(4,647)
Net deferred loan costs	238	170
Net loans	450,973	456,636
Accrued interest receivable	1,741	1,663
Premises and equipment, net	10,979	10,678
Core deposit intangible	1,181	1,267
Goodwill	2,223	2,223
Investment in real estate limited partnerships	2,791	3,119
Company-owned life insurance	3,477	3,393
Other assets	8,103	8,800
Total assets	$571,488	$585,443
Liabilities and Stockholders’ Equity		
Liabilities		
Deposits		
Noninterest bearing	$81,140	$87,247
Interest bearing	290,980	269,614
Time	118,736	161,493
Total deposits	490,856	518,354
Borrowed funds	24,759	13,216
Accrued interest and other liabilities	3,986	4,053
Total liabilities	519,601	535,623
Commitments and Contingencies		
Stockholders’ Equity		
Common stock, $2.00 par value; 7,500,000 shares authorized; 4,928,996 shares issued at June 30, 2014 and 4,927,286 shares issued at December 31, 2013	9,858	9,855
Additional paid-in capital	404	363
Retained earnings	44,769	43,405
Treasury stock at cost; 470,742 shares at June 30, 2014 and 468,927 shares at December 31, 2013	(3,922)	(3,880)
Accumulated other comprehensive income	778	77
Total stockholders' equity	51,887	49,820
Total liabilities and stockholders' equity	$571,488	$585,443

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands, except per share data)			
Interest and dividend income				
Interest and fees on loans	$5,828	$5,787	$11,590	$11,455
Interest on debt securities:				
Taxable	206	140	411	250
Tax exempt	91	70	172	140
Dividends	16	13	31	29
Interest on federal funds sold and overnight deposits	4	10	8	23
Interest on interest bearing deposits in banks	39	59	84	119
Total interest and dividend income	6,184	6,079	12,296	12,016
Interest expense				
Interest on deposits	421	486	893	1,004
Interest on borrowed funds	108	127	213	257
Total interest expense	529	613	1,106	1,261
Net interest income	5,655	5,466	11,190	10,755
Provision for loan losses	75	75	150	135
Net interest income after provision for loan losses	5,580	5,391	11,040	10,620
Noninterest income				
Trust income	191	154	366	317
Service fees	1,285	1,257	2,557	2,446
Net gains (losses) on sales of investment securities available-for-sale	19	(4)	62	(1)
Net gains on sales of loans held for sale	508	583	941	1,250
Other income	107	130	147	264
Total noninterest income	2,110	2,120	4,073	4,276
Noninterest expenses				
Salaries and wages	2,194	2,235	4,441	4,392
Pension and employee benefits	703	638	1,370	1,321
Occupancy expense, net	295	291	634	622
Equipment expense	410	388	797	814
Other expenses	1,668	1,670	3,217	3,252
Total noninterest expenses	5,270	5,222	10,459	10,401
Income before provision for income taxes	2,420	2,289	4,654	4,495
Provision for income taxes	501	492	971	961
Net income	$1,919	$1,797	$3,683	$3,534
Earnings per common share	$0.43	$0.40	$0.83	$0.79
Weighted average number of common shares outstanding	4,458,439	4,456,802	4,458,359	4,456,315
Dividends per common share	$0.26	$0.25	$0.52	$0.50

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Net income	$1,919	$1,797	$3,683	$3,534
Other comprehensive income (loss), net of tax:				
Investment securities available-for-sale:				
Net unrealized holding gains (losses) arising during the period on investment securities available-for-sale	357	(618)	742	(609)
Reclassification adjustment for net (gains) losses on investment securities available-for-sale realized in net income	(13)	3	(41)	1
Total	344	(615)	701	(608)
Defined benefit pension plan:				
Net actuarial loss arising during the period	—	—	—	(33)
Reclassification adjustment for amortization of net actuarial loss realized in net income	—	63	—	63
Total	—	63	—	30
Total other comprehensive income (loss)	344	(552)	701	(578)
Total comprehensive income	$2,263	$1,245	$4,384	$2,956

See accompanying notes to unaudited interim consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Six Months Ended June 30, 2014 and 2013 (Unaudited)

	Common Stock						
	Shares, net of treasury	Amount	Additional paid-in capital	Retained earnings	Treasury stock	Accumulated other comprehensive income (loss)	Total stockholders' equity
	(Dollars in thousands, except per share data)						
Balances, December 31, 2013	4,458,359	$9,855	$363	$43,405	$(3,880)	$77	$49,820
Net income	—	—	—	3,683	—	—	3,683
Other comprehensive income	—	—	—	—	—	701	701
Cash dividends declared ($0.52 per share)	—	—	—	(2,319)	—	—	(2,319)
Stock based compensation expense	—	—	11	—	—	—	11
Exercise of stock options	1,710	3	30	—	—	—	33
Purchase of treasury stock	(1,815)	—	—	—	(42)	—	(42)
Balances, June 30, 2014	4,458,254	$9,858	$404	$44,769	$(3,922)	$778	$51,887
Balances, December 31, 2012	4,456,081	$9,848	$295	$40,772	$(3,859)	$(2,010)	$45,046
Net income	—	—	—	3,534	—	—	3,534
Other comprehensive loss	—	—	—	—	—	(578)	(578)
Cash dividends declared ($0.50 per share)	—	—	—	(2,228)	—	—	(2,228)
Stock based compensation expense	—	—	6	—	—	—	6
Exercise of stock options	1,800	4	29	—	—	—	33
Purchase of treasury stock	(925)	—	—	—	(19)	—	(19)
Balances, June 30, 2013	4,456,956	$9,852	$330	$42,078	$(3,878)	$(2,588)	$45,794

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended June 30, 2014	2013
	(Dollars in thousands)	
Cash Flows From Operating Activities		
Net income	$3,683	$3,534
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	463	464
Provision for loan losses	150	135
Deferred income tax provision	73	138
Net amortization of investment securities	37	24
Equity in losses of limited partnerships	328	345
Stock based compensation expense	11	6
Net (increase) decrease in unamortized loan costs	(68)	9
Proceeds from sales of loans held for sale	43,439	67,450
Origination of loans held for sale	(45,320)	(59,646)
Net gains on sales of loans held for sale	(941)	(1,250)
Net (gains) losses on sales of investment securities available-for-sale	(62)	1
Write-downs of impaired assets	—	36
Net (gains) losses on sales of other real estate owned	(6)	5
Increase in accrued interest receivable	(78)	(34)
Amortization of core deposit intangible	86	86
(Increase) decrease in other assets	(180)	879
(Decrease) increase in other liabilities	(67)	261
Net cash provided by operating activities	1,548	12,443
Cash Flows From Investing Activities		
Interest bearing deposits in banks		
Proceeds from maturities and redemptions	5,779	4,379
Purchases	(1,879)	(4,719)
Investment securities held-to-maturity		
Proceeds from maturities, calls and paydowns	3,571	500
Purchases	(2,000)	(4,216)
Investment securities available-for-sale		
Proceeds from sales	4,426	1,015
Proceeds from maturities, calls and paydowns	2,725	2,798
Purchases	(12,144)	(11,949)
Redemption of nonmarketable stock	—	(77)
Net decrease (increase) in loans	5,561	(705)
Recoveries of loans charged off	20	26
Purchases of premises and equipment	(764)	(359)
Proceeds from sales of other real estate owned	365	367
Net cash provided by (used in) investing activities	5,660	(12,940)

Cash Flows From Financing Activities		
Repayment of long-term debt	(176)	(935)
Net increase in short-term borrowings outstanding	11,719	5,366
Net decrease in noninterest bearing deposits	(6,107)	(3,827)
Net increase (decrease) in interest bearing deposits	21,366	(7,329)
Net decrease in time deposits	(42,757)	(24,820)
Issuance of common stock	33	33
Purchase of treasury stock	(42)	(19)
Dividends paid	(2,319)	(2,228)
Net cash used in financing activities	(18,283)	(33,759)
Net decrease in cash and cash equivalents	(11,075)	(34,256)
Cash and cash equivalents		
Beginning of period	30,719	46,510
End of period	$19,644	$12,254
Supplemental Disclosures of Cash Flow Information		
Interest paid	$1,307	$1,456
Income taxes paid	$670	$650

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation
The accompanying unaudited interim consolidated financial statements of Union Bankshares, Inc. and Subsidiary (the Company) as of June 30, 2014, and for the three and six months ended June 30, 2014 and 2013, have been prepared in conformity with GAAP for interim financial information, general practices within the banking industry, and the accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The Company's sole subsidiary is Union Bank. In the opinion of the Company's management, all adjustments, consisting only of normal recurring adjustments and disclosures necessary for a fair presentation of the information contained herein, have been made. This information should be read in conjunction with the Company's 2013 Annual Report on Form 10-K. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year ended December 31, 2014, or any other interim period.
Certain amounts in the 2013 consolidated financial statements have been reclassified to conform to the 2014 presentation.

The acronyms, abbreviations and capitalized terms identified below are used throughout this Form 10-Q, including Part I. "Financial Information" and Part II. "Other Information". The following is provided to aid the reader and provide a reference page when reviewing this Form 10-Q.

AFS:	Available-for-sale	IRS:	Internal Revenue Service
ALL:	Allowance for loan losses	MBS:	Mortgage-backed security
ASC:	Accounting Standards Codification	MSRs:	Mortgage servicing rights
ASU:	Accounting Standards Update	OAO:	Other assets owned
Board:	Board of Directors	OCI:	Other comprehensive income (loss)
bp or bps:	Basis point(s)	OFAC:	U.S. Office of Foreign Assets Control
Branch Acquisition:	The acquisition of three New Hampshire branches in May 2011	OREO:	Other real estate owned
CDARS:	Certificate of Deposit Accounts Registry Service of the Promontory Interfinancial Network	OTTI:	Other-than-temporary impairment
Company:	Union Bankshares, Inc. and Subsidiary	OTT:	Other-than-temporary
FASB:	Financial Accounting Standards Board	Plan:	The Union Bank Pension Plan
FDIC:	Federal Deposit Insurance Corporation	RD:	USDA Rural Development
FHA:	U.S. Federal Housing Administration	SBA:	U.S. Small Business Administration
FHLB:	Federal Home Loan Bank of Boston	SEC:	U.S. Securities and Exchange Commission
FRB:	Federal Reserve Board	TDR:	Troubled-debt restructuring
FHLMC/Freddie Mac:	Federal Home Loan Mortgage Corporation	Union:	Union Bank, the sole subsidiary of Union Bankshares, Inc
GAAP:	Generally accepted accounting principles in the United States	USDA:	U.S. Department of Agriculture
HTM:	Held-to-maturity	VA:	U.S. Veterans Administration
HUD:	U.S. Department of Housing and Urban Development	2008 ISO Plan:	2008 Incentive Stock Option Plan of the Company
ICS:	Insured Cash Sweeps of the Promontory Interfinancial Network	2014 Equity Plan:	2014 Equity Incentive Plan

Note 2. Legal Contingencies
In the normal course of business, the Company is involved in various legal and other proceedings. In the opinion of management, any liability resulting from such proceedings is not expected to have a material adverse effect on the

Company’s consolidated financial condition or results of operations.

Note 3. Per Share Information
Earnings per common share are computed based on the weighted average number of shares of common stock outstanding during the period and reduced for shares held in treasury. The assumed conversion of outstanding exercisable stock options does not result in material dilution and is not included in the calculation.

Note 4. Recent Accounting Pronouncements
In January 2014, the FASB issued ASU No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. The amendments in this ASU permit institutions to make accounting policy elections to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). For those investments in qualified affordable housing projects not accounted for using the proportional amortization method, the ASU requires the investment to be accounted for as an equity method investment or a cost method investment. The amendments in this ASU 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 amendments in this ASU are effective for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. Management has reviewed the ASU and does not believe that it will have a material effect on the Company's consolidated financial position or results of operations.

In January 2014, the FASB issued ASU No. 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in this ASU clarify that an in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The amendments in this ASU are effective for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Management has reviewed the ASU and does not believe that it will have a material effect on the Company's consolidated financial position or results of operations.

Note 5. Goodwill and Other Intangible Assets
As a result of the 2011 Branch Acquisition , the Company recorded goodwill amounting to $2.2 million. The goodwill is not amortizable. Goodwill is evaluated for impairment annually, in accordance with current authoritative accounting guidance. Management assesses qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of the Company, in total, is less than its carrying amount. Management is not aware of any such events or circumstances that would cause it to conclude that the fair value of the Company is less than its carrying amount.

The Company also recorded $1.7 million of acquired identifiable intangible assets in connection with the branch acquisition, representing the core deposit intangible which is subject to straight-line amortization over the estimated 10 year average life of the core deposit base, absent any future impairment. Management will evaluate the core deposit intangible for impairment if conditions warrant.

Amortization expense for the core deposit intangible was $43 thousand for the three months ended June 30, 2014 and 2013 and was $86 thousand for the six months ended June 30, 2014 and 2013. The amortization expense is included in other noninterest expense on the consolidated statement of income and is deductible for tax purposes. As of June 30, 2014, the remaining amortization expense related to the core deposit intangible, absent any future impairment, is expected to be as follows:

	(Dollars in thousands)
2014	$85
2015	171
2016	171
2017	171
2018	171
Thereafter	412
Total	$1,181

Note 6. Investment Securities

Investment securities as of the balance sheet dates consisted of the following:

June 30, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
Available-for-sale				
Debt securities:				
U.S. Government-sponsored enterprises	$11,895	$3	$(358)	$11,540
Agency mortgage-backed	5,897	45	(27)	5,915
State and political subdivisions	14,764	343	(59)	15,048
Corporate	6,498	68	(63)	6,503
Total debt securities	39,054	459	(507)	39,006
Marketable equity securities	746	332	—	1,078
Mutual funds	275	—	—	275
Total	$40,075	$791	$(507)	$40,359
Held-to-maturity				
U.S. Government-sponsored enterprises	$9,642	$4	$(351)	$9,295

December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
Available-for-sale				
Debt securities:				
U.S. Government-sponsored enterprises	$14,327	$11	$(1,101)	$13,237
Agency mortgage-backed	3,804	18	(75)	3,747
State and political subdivisions	11,930	328	(94)	12,164
Corporate	3,994	—	(160)	3,834
Total debt securities	34,055	357	(1,430)	32,982
Marketable equity securities	746	296	(1)	1,041
Mutual funds	258	—	—	258
Total	$35,059	$653	$(1,431)	$34,281
Held-to-maturity				
U.S. Government-sponsored enterprises	$11,211	$2	$(849)	$10,364

Proceeds from the sale of AFS securities were $2.0 million and $4.4 million for the three and six months ended June 30, 2014, respectively. Gross realized gains from the sale of AFS securities were $19 thousand and $62 thousand for the three and six months ended June 30, 2014, respectively, while there were no gross realized losses for either period. Proceeds from the sale of AFS securities were $504 thousand and $1.0 million for the three and six months ended June 30, 2013, respectively. Gross realized gains from the sale of AFS securities were $0 and $3 thousand for the three and six months ended June 30, 2013, respectively, while gross realized losses were $4 thousand for both periods. The specific identification method is used to determine realized gains and losses on sales of securities AFS.

The amortized cost and estimated fair value of debt securities by contractual scheduled maturity as of June 30, 2014 were as follows:

	Amortized Cost	Fair Value
	(Dollars in thousands)	
Available-for-sale		
Due in one year or less	$827	$827
Due from one to five years	3,813	3,855
Due from five to ten years	17,780	17,778
Due after ten years	10,737	10,631
	33,157	33,091
Agency mortgage-backed	5,897	5,915
Total debt securities available-for-sale	$39,054	$39,006
Held-to-maturity		
Due from one to five years	$1,996	$1,988
Due from five to ten years	2,000	1,930
Due after ten years	5,646	5,377
Total debt securities held-to-maturity	$9,642	$9,295

Actual maturities may differ for certain debt securities that may be called by the issuer prior to the contractual maturity. Actual maturities usually differ from contractual maturities on agency MBS because the mortgages underlying the securities may be prepaid, usually without any penalties. Therefore, these agency MBS are shown separately and are not included in the contractual maturity categories in the above maturity summary.

Information pertaining to all investment securities with gross unrealized losses as of the balance sheet dates, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

June 30, 2014	Less Than 12 Months			12 Months and over			Total		
	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses
		(Dollars in thousands)							
Debt securities:									
U.S. Government-sponsored enterprises	—	$—	$—	20	$16,314	$(709)	20	$16,314	$(709)
Agency mortgage-backed	1	464	(5)	2	846	(22)	3	1,310	(27)
State and political subdivisions	7	2,267	(28)	2	573	(31)	9	2,840	(59)
Corporate	3	1,204	(1)	3	1,457	(62)	6	2,661	(63)
Total	11	$3,935	$(34)	27	$19,190	$(824)	38	$23,125	$(858)

December 31, 2013	Less Than 12 Months			12 Months and over			Total		
	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses
		(Dollars in thousands)							
Debt securities:									
U.S. Government-sponsored enterprises	21	$16,213	$(1,292)	6	$4,839	$(658)	27	$21,052	$(1,950)
Agency mortgage-backed	6	2,844	(75)	—	—	—	6	2,844	(75)
State and political subdivisions	9	3,175	(72)	1	329	(22)	10	3,504	(94)
Corporate	6	2,420	(53)	3	1,414	(107)	9	3,834	(160)
Total debt securities	42	24,652	(1,492)	10	6,582	(787)	52	31,234	(2,279)
Marketable equity securities	—	—	—	1	13	(1)	1	13	(1)
Total	42	$24,652	$(1,492)	11	$6,595	$(788)	53	$31,247	$(2,280)

The Company evaluates all investment securities on a quarterly basis, and more frequently when economic conditions warrant, to determine if OTTI exists. A security is considered impaired if the fair value is lower than its amortized cost basis at the report date. If impaired, management then assesses whether the unrealized loss is OTT.

Declines in the fair values of individual equity securities that are deemed to be OTT are reflected in noninterest income when identified. An unrealized loss on a debt security is generally deemed to be OTT and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. The credit loss component of OTTI write-down is recorded, net of tax effect, through net income as a component of net OTTI losses in the consolidated statement of income, while the remaining portion of the impairment loss is recognized in OCI, provided the Company does not intend to sell the underlying debt security and it is "more likely than not" that the Company will not have to sell the debt security prior to recovery.

Management considers the following factors in determining whether OTTI exists and the period over which the debt security is expected to recover:

- The length of time, and extent to which, the fair value has been less than the amortized cost;

- Adverse conditions specifically related to the security, industry, or geographic area;
- The historical and implied volatility of the fair value of the security;
- The payment structure of the debt security and the likelihood of the issuer being able to make payments that may increase in the future;
- Failure of the issuer of the security to make scheduled interest or principal payments;
- Any changes to the rating of the security by a rating agency;
- Recoveries or additional declines in fair value subsequent to the balance sheet date; and

- The nature of the issuer, including whether it is a private company, public entity or government-sponsored enterprise, and the existence or likelihood of any government or third party guaranty.

The Company has the ability to hold the investment securities that had unrealized losses at June 30, 2014 for the foreseeable future and no declines were deemed by management to be OTT.

Investment securities with a carrying amount of $3.1 million and $3.3 million at June 30, 2014 and December 31, 2013, respectively, were pledged as collateral for public deposits and for other purposes as required or permitted by law.

Note 7. Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their unpaid principal balances, adjusted for any charge-offs, the ALL, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

Loan interest income is accrued daily on outstanding balances. The following accounting policies, related to accrual and nonaccrual loans, apply to all portfolio segments and to all loan classes, which the Company considers to be the same as the portfolio segments. The accrual of interest is normally discontinued when a loan is specifically determined to be impaired and/or management believes, after considering collection efforts and other factors, that the borrower's financial condition is such that collection of interest is doubtful. Generally, any unpaid interest previously accrued on those loans is reversed against current period interest income. A loan may be restored to accrual status when its financial status has significantly improved and there is no principal or interest past due. A loan may also be restored to accrual status if the borrower makes six consecutive monthly payments or the lump sum equivalent. Income on nonaccrual loans is generally not recognized unless a loan is returned to accrual status or after all principal has been collected. Interest income generally is not recognized on impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are generally recorded as a reduction of the loan principal balance. Delinquency status is determined based on contractual terms for all portfolio segments and loan classes. Loans past due 30 days or more are considered delinquent.

Loan origination fees and direct loan origination costs are deferred and amortized as an adjustment of the related loan's yield using methods that approximate the interest method. The Company generally amortizes these amounts over the estimated average life of the related loans.

The loans purchased in the 2011 Branch Acquisition were recorded at $32.9 million, the estimated fair value at the time of purchase. The estimated fair value contains both accretable and nonaccretable components. The accretable component is amortized as an adjustment to the related loan yield over the average life of the loan. The nonaccretable component represents probable loss due to credit risk and is reviewed by management periodically and adjusted as deemed necessary. At the acquisition date, the fair value of the loans acquired resulted in an accretable loan premium component of $545 thousand, less a nonaccretable credit risk component of $318 thousand.

The following table summarizes activity in the accretable loan premium component for the acquired loan portfolio:

	For The Three Months Ended June 30,		For The Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Balance at beginning of period	$354	$434	$374	$454
Loan premium amortization	(20)	(20)	(40)	(40)
Balance at end of period	$334	$414	$334	$414

Loan premium amortization has been charged to Interest and fees on loans on the Company's consolidated statements of income for the periods reported. The remaining accretable loan premium component balance was $334 thousand at June 30, 2014 and $374 thousand at December 31, 2013. The balance of the nonaccretable credit risk component was $296 thousand at June 30, 2014 and December 31, 2013. The net carrying amounts of the acquired loans were $16.5 million and $17.0 million at June 30, 2014 and December 31, 2013, respectively, and are included in the loan balances below.

The composition of Net loans as of the balance sheet dates were as follows:

	June 30, 2014	December 31, 2013
	(Dollars in thousands)	
Residential real estate	$160,662	$159,441
Construction real estate	31,755	30,898
Commercial real estate	218,517	210,718
Commercial	23,264	20,569
Consumer	4,493	5,396
Municipal	16,654	34,091
Gross loans	455,345	461,113
Allowance for loan losses	(4,610)	(4,647)
Net deferred loan costs	238	170
Net loans	$450,973	$456,636

Residential real estate loans aggregating $3.7 million and $22.7 million at June 30, 2014 and December 31, 2013, respectively, were pledged as collateral on deposits of municipalities. Qualifying residential first mortgage loans held by Union may be pledged as collateral for borrowings from the FHLB under a blanket lien.

A summary of current, past due and nonaccrual loans as of the balance sheet dates follows:

June 30, 2014	Current	30-59 Days	60-89 Days	90 Days and Over and Accruing	Nonaccrual	Total
	(Dollars in thousands)					
Residential real estate	$157,842	$128	$1,235	$508	$949	$160,662
Construction real estate	31,675	—	41	12	27	31,755
Commercial real estate	215,436	1,698	122	434	827	218,517
Commercial	23,182	—	37	—	45	23,264
Consumer	4,443	6	12	2	30	4,493
Municipal	16,654	—	—	—	—	16,654
Total	$449,232	$1,832	$1,447	$956	$1,878	$455,345

December 31, 2013	Current	30-59 Days	60-89 Days	90 Days and Over and Accruing	Nonaccrual	Total
	(Dollars in thousands)					
Residential real estate	$153,469	$3,371	$1,247	$262	$1,092	$159,441
Construction real estate	30,513	300	59	—	26	30,898
Commercial real estate	207,429	1,117	1,938	—	234	210,718
Commercial	20,326	195	—	—	48	20,569
Consumer	5,295	66	—	1	34	5,396
Municipal	34,091	—	—	—	—	34,091
Total	$451,123	$5,049	$3,244	$263	$1,434	$461,113

Aggregate interest on nonaccrual loans not recognized was $1.0 million and $1.1 million as of June 30, 2014 and 2013, respectively, and $1.1 million as of December 31, 2013.

Note 8. Allowance for Loan Losses and Credit Quality

The ALL is established for estimated losses in the loan portfolio through a provision for loan losses charged to earnings. For all loan classes, loan losses are charged against the ALL when management believes the loan balance is uncollectible or in accordance with federal guidelines. Subsequent recoveries, if any, are credited to the ALL.

The ALL is maintained at a level believed by management to be appropriate to absorb probable credit losses inherent in the loan portfolio as of the balance sheet date. The amount of the ALL is based on management's periodic evaluation of the collectability of the loan portfolio, including the nature, volume and risk characteristics of the portfolio, credit concentrations, trends in historical loss experience, estimated value of any underlying collateral, specific impaired loans and economic conditions. There has been no change to the methodology used to estimate the ALL during the second quarter of 2014. While management uses available information to recognize losses on loans, future additions to the ALL may be necessary based on changes in economic conditions or other relevant factors.

In addition, various regulatory agencies, as an integral part of their examination process, regularly review the Company's ALL. Such agencies may require the Company to recognize additions to the ALL, with a corresponding charge to earnings, based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

The ALL consists of specific, general and unallocated components. The specific component relates to the loans that are classified as impaired. Loans are evaluated for impairment and may be classified as impaired when management believes it is probable that the Company will not collect all the contractual interest and principal payments as scheduled in the loan agreement. Impaired loans may also include troubled loans that are restructured. A TDR occurs when the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that would otherwise not be granted. A TDR classification may result from the transfer of assets to the Company in partial satisfaction of a troubled loan, a modification of a loan's terms (such as reduction of stated interest rates below market rates, extension of maturity that does not conform to the Company's policies, reduction of the face amount of the loan, reduction of accrued interest, or reduction or deferment of loan payments), or a combination of factors. A specific reserve amount is allocated to the allowance for individual loans that have been classified as impaired based on management's estimate of the fair value of the collateral for collateral dependent loans, an observable market price, or the present value of anticipated future cash flows. The Company accounts for the change in present value attributable to the passage of time in the loan loss reserve. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, real estate or small balance commercial loans for impairment evaluation, unless such loans are subject to a restructuring agreement or have been identified as impaired as part of a larger customer relationship. Management has established the threshold for individual impairment evaluation for commercial loans with balances greater than $500 thousand, based on an evaluation of the Company's historical loss experience on substandard commercial loans.

The general component represents the level of ALL allocable to each loan portfolio segment with similar risk characteristics and is determined based on historical loss experience, adjusted for qualitative factors, for each class of loan. Management deems a five year average to be an appropriate time frame on which to base historical losses for each portfolio segment. Qualitative factors considered include underwriting, economic and market conditions, portfolio composition, collateral values, delinquencies, lender experience and legal issues. The qualitative factors are determined based on the various risk characteristics of each portfolio segment. Risk characteristics relevant to each portfolio segment are as follows:

- Residential real estate - Loans in this segment are collateralized by owner-occupied 1-4 family residential real estate, second and vacation homes, 1-4 family investment properties, home equity and second mortgage loans. Repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, could have an effect on the credit quality of this segment.

- Construction real estate - Loans in this segment include residential and commercial construction properties, land and land development loans. Repayment is dependent on the credit quality of the individual borrower and/or the underlying cash flows generated by the properties being constructed. The overall health of the economy, including unemployment rates, housing prices, vacancy rates and material costs, could have an effect on the credit quality of this segment.

- Commercial real estate - Loans in this segment are primarily properties occupied by businesses or income-producing properties. The underlying cash flows generated by the properties may be adversely impacted by a downturn in the economy as evidenced by a general slowdown in business or increased vacancy rates which, in turn, could have an effect on the credit quality of this segment. Management requests business financial statements at least annually and monitors the cash flows of these loans.

- Commercial - Loans in this segment are made to businesses and are generally secured by nonreal estate assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer or business spending, could have an effect on the credit quality of this segment.

- Consumer - Loans in this segment are made to individuals for personal expenditures, such as an automobile purchase, and include unsecured loans. Repayment is primarily dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment, could have an effect on the credit quality of this segment.

- Municipal - Loans in this segment are made to municipalities located within the Company's service area. Repayment is primarily dependent on taxes or other funds collected by the municipalities. Management considers there to be minimal risk surrounding the credit quality of this segment.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the ALL reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

All evaluations are inherently subjective as they require estimates that are susceptible to significant revision as more information becomes available or as changes occur in economic conditions or other relevant factors. Despite the allocation shown in the tables below, the ALL is general in nature and is available to absorb losses from any loan segment.

Changes in the ALL, by class of loans, for the three and six months ended June 30, 2014 and 2013 were as follows:

For The Three Months Ended June 30, 2014	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Balance, March 31, 2014	$1,237	$374	$2,575	$169	$22	$43	$274	$4,694
Provision (credit) for loan losses	39	12	164	36	3	(25)	(154)	75
Recoveries of amounts charged off	—	3	—	1	2	—	—	6
	1,276	389	2,739	206	27	18	120	4,775
Amounts charged off	(18)	—	(142)	—	(5)	—	—	(165)
Balance, June 30, 2014	$1,258	$389	$2,597	$206	$22	$18	$120	$4,610
For The Three Months Ended June 30, 2013	**Residential Real Estate**	**Construction Real Estate**	**Commercial Real Estate**	**Commercial**	**Consumer**	**Municipal**	**Unallocated**	**Total**
	(Dollars in thousands)							
Balance, March 31, 2013	$1,281	$373	$2,722	$175	$34	$32	$97	$4,714
Provision (credit) for loan losses	24	71	47	36	(1)	(18)	(84)	75
Recoveries of amounts charged off	9	3	—	2	1	—	—	15
	1,314	447	2,769	213	34	14	13	4,804
Amounts charged off	(16)	(16)	—	(18)	(2)	—	—	(52)
Balance, June 30, 2013	$1,298	$431	$2,769	$195	$32	$14	$13	$4,752
For The Six Months Ended June 30, 2014	**Residential Real Estate**	**Construction Real Estate**	**Commercial Real Estate**	**Commercial**	**Consumer**	**Municipal**	**Unallocated**	**Total**
	(Dollars in thousands)							
Balance, December 31, 2013	$1,251	$390	$2,644	$163	$23	$35	$141	$4,647
Provision (credit) for loan losses	60	(7)	95	41	(1)	(17)	(21)	150

Recoveries of amounts charged off	2	6	—	2	10	—	—	20
	1,313	389	2,739	206	32	18	120	4,817
Amounts charged off	(55)	—	(142)	—	(10)	—	—	(207)
Balance, June 30, 2014	$1,258	$389	$2,597	$206	$22	$18	$120	$4,610

For The Six Months Ended June 30, 2013	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Balance, December 31, 2012	$1,291	$456	$2,532	$159	$39	$30	$150	$4,657
Provision (credit) for loan losses	23	(15)	237	51	(8)	(16)	(137)	135
Recoveries of amounts charged off	10	6	—	3	7	—	—	26
	1,324	447	2,769	213	38	14	13	4,818
Amounts charged off	(26)	(16)	—	(18)	(6)	—	—	(66)
Balance, June 30, 2013	$1,298	$431	$2,769	$195	$32	$14	$13	$4,752

The allocation of the ALL, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

June 30, 2014	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Individually evaluated for impairment	$40	$2	$134	$—	$—	$—	$—	$176
Collectively evaluated for impairment	1,218	387	2,463	206	22	18	120	4,434
Total allocated	$1,258	$389	$2,597	$206	$22	$18	$120	$4,610

December 31, 2013	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Individually evaluated for impairment	$46	$13	$278	$—	$—	$—	$—	$337
Collectively evaluated for impairment	1,205	377	2,366	163	23	35	141	4,310
Total allocated	$1,251	$390	$2,644	$163	$23	$35	$141	$4,647

The recorded investment in loans, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

June 30, 2014	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Individually evaluated for impairment	$645	$301	$4,227	$99	$—	$—	$5,272
Collectively evaluated for impairment	152,948	31,454	205,620	22,945	4,388	16,212	433,567
	153,593	31,755	209,847	23,044	4,388	16,212	438,839
Acquired loans	7,069	—	8,670	220	105	442	16,506
Total	$160,662	$31,755	$218,517	$23,264	$4,493	$16,654	$455,345

December 31, 2013	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Individually evaluated for impairment	$821	$348	$4,219	$109	$—	$—	$5,497
Collectively evaluated for impairment	151,297	30,550	197,696	20,145	5,264	33,627	438,579
	152,118	30,898	201,915	20,254	5,264	33,627	444,076
Acquired loans	7,323	—	8,803	315	132	464	17,037
Total	$159,441	$30,898	$210,718	$20,569	$5,396	$34,091	$461,113

Risk and collateral ratings are assigned to loans and are subject to ongoing monitoring by lending and credit personnel with such ratings updated annually or more frequently if warranted. The following is an overview of the Company's loan rating system:

1-3 Rating - Pass
Risk-rating grades "1" through "3" comprise those loans ranging from those with lower than average credit risk, defined as borrowers with high liquidity, excellent financial condition, strong management, favorable industry trends or loans secured by highly liquid assets, through those with marginal credit risk, defined as borrowers that, while creditworthy, exhibit some characteristics requiring special attention by the account officer.

4/M Rating - Satisfactory/Monitor
Borrowers exhibit potential credit weaknesses or downward trends warranting management's attention. While potentially weak, these borrowers are currently marginally acceptable; no loss of principal or interest is envisioned. When warranted, these credits may be monitored on the watch list.

5-7 Rating - Substandard
Borrowers exhibit well defined weaknesses that jeopardize the orderly liquidation of debt. The loan may be inadequately protected by the net worth and paying capacity of the obligor and/or the underlying collateral is inadequate.

The following tables summarize the loan ratings applied to the Company's loans by class as of the balance sheet dates:

June 30, 2014	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Pass	$143,965	$29,254	$161,740	$20,603	$4,307	$16,212	$376,081
Satisfactory/Monitor	7,494	2,200	40,618	2,147	73	—	52,532
Substandard	2,134	301	7,489	294	8	—	10,226
Total	153,593	31,755	209,847	23,044	4,388	16,212	438,839
Acquired loans	7,069	—	8,670	220	105	442	16,506
Total	$160,662	$31,755	$218,517	$23,264	$4,493	$16,654	$455,345

December 31, 2013	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Pass	$141,909	$29,648	$145,225	$17,309	$5,180	$33,627	$372,898
Satisfactory/Monitor	7,953	891	50,198	2,694	82	—	61,818
Substandard	2,256	359	6,492	251	2	—	9,360
Total	152,118	30,898	201,915	20,254	5,264	33,627	444,076

Acquired loans	7,323	—	8,803	315	132	464	17,037
Total	$159,441	$30,898	$210,718	$20,569	$5,396	$34,091	$461,113

Acquired loans are risk rated, as appropriate, according to the Company's loan rating system, but such ratings are not taken into account in establishing the ALL. Rather, in accordance with applicable accounting principles, acquired loans are initially recorded at fair value, determined based upon an estimate of the amount and timing of both principal and interest cash flows expected to be collected and discounted using a market interest rate, which includes an estimate of future credit losses expected to be incurred over the life of the portfolio. The primary credit quality indicator for acquired loans is whether there has been a decrease in expected cash flows. Monitoring of this portfolio is ongoing to determine if there is evidence of deterioration in credit quality since acquisition. As of June 30, 2014, there was no ALL for acquired loans.

The following table provides information with respect to impaired loans by class of loan as of and for the three and six months ended June 30, 2014:

	As of June 30, 2014			For The Three Months Ended June 30, 2014		For The Six Months Ended June 30, 2014	
	Recorded Investment	Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)						
With an allowance recorded:							
Residential real estate	$336	$345	$40				
Construction real estate	99	99	2				
Commercial real estate	2,185	2,189	134				
	2,620	2,633	176				
With no allowance recorded:							
Residential real estate	309	485	—				
Construction real estate	202	224	—				
Commercial real estate	2,042	2,088	—				
Commercial	99	99	—				
	2,652	2,896	—				
Total:							
Residential real estate	645	830	40	$648	$5	$706	$10
Construction real estate	301	323	2	325	4	333	8
Commercial real estate	4,227	4,277	134	4,230	45	4,226	87
Commercial	99	99	—	102	2	104	4
Total	$5,272	$5,529	$176	$5,305	$56	$5,369	$109

The following table provides information with respect to impaired loans by class of loan as of and for the three and six months ended June 30, 2013:

	As of June 30, 2013			For The Three Months Ended June 30, 2013		For The Six Months Ended June 30, 2013	
	Recorded Investment (1)	Principal Balance (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)						
Total:							
Residential real estate	$888	$1,058	$51	$820	$4	$781	$8
Construction real estate	351	373	16	246	1	213	2
Commercial real estate	3,262	3,358	20	3,329	41	3,362	70
Commercial	117	117	3	120	2	122	4
Total	$4,618	$4,906	$90	$4,515	$48	$4,478	$84

(1) Does not reflect government guaranties on impaired loans as of June 30, 2013 totaling $750 thousand.

The following table provides information with respect to impaired loans as of December 31, 2013:

	December 31, 2013		
	Recorded Investment (1)	Principal Balance (1)	Related Allowance
	(Dollars in thousands)		
With an allowance recorded:			
Residential real estate	$437	$451	$46
Construction real estate	322	322	13
Commercial real estate	2,534	2,534	278
	3,293	3,307	337
With no allowance recorded:			
Residential real estate	384	612	—
Construction real estate	26	48	—
Commercial real estate	1,685	1,742	—
Commercial	109	109	—
	2,204	2,511	—
Total:			
Residential real estate	821	1,063	46
Construction real estate	348	370	13
Commercial real estate	4,219	4,276	278
Commercial	109	109	—
Total	$5,497	$5,818	$337

(1) Does not reflect government guaranties on impaired loans as of December 31, 2013 totaling $669 thousand.

The following is a summary of TDR loans by class of loan as of the balance sheet dates:

	June 30, 2014		December 31, 2013	
	Number of Loans	Principal Balance	Number of Loans	Principal Balance
Residential real estate	4	$390	4	$402
Construction real estate	3	301	3	349
Commercial real estate	4	1,552	2	489
Total	11	$2,243	9	$1,240

The TDR loans above represent loan modifications in which a concession was provided to the borrower, including due date extensions, maturity date extensions, interest rate reductions or the forgiveness of accrued interest. Troubled loans, that are restructured and meet established thresholds, are classified as impaired and a specific reserve amount is allocated to the ALL on the basis of the fair value of the collateral for collateral dependent loans, an observable market price, or the present value of anticipated future cash flows.

There was no new TDR activity during the for the the three and six months ended June 30, 2013 or the three months ended June 30, 2014. The following table provides new TDR activity for the six months ended June 30, 2014:

	New TDRs During the Six Months Ended June 30, 2014		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(Dollars in thousands)		
Commercial real estate	2	$ 1,018	$ 1,068

There were no TDR loans modified within the previous twelve months that had subsequently defaulted during the three and six month periods ended June 30, 2014 or June 30, 2013. TDR loans are considered defaulted at 90 days past due.

At June 30, 2014 and December 31, 2013, the Company was not committed to lend any additional funds to borrowers whose loans were nonperforming, impaired or restructured.

Note 9. Defined Benefit Pension Plan

Union Bank, the Company's sole subsidiary, sponsors a noncontributory defined benefit pension plan covering all eligible employees employed prior to October 5, 2012. On October 5, 2012, the Company closed the Plan to new participants and froze the accrual of retirement benefits for current participants. It is Union's current intent to continue to maintain the frozen Plan and related Trust account and to distribute benefits to participants at such time and in such manner as provided under the terms of the Plan. The Company will continue to recognize pension (benefit) expense and cash funding obligations for the remaining life of the associated liability for the frozen benefits under the Plan. The Plan provides defined benefits based on years of service and final average salary prior to October 5, 2012.

Net periodic pension (benefit) expense for the three and six months ended June 30 consisted of the following components:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Service cost	$—	$—	$—	$—
Interest cost on projected benefit obligation	193	175	386	350
Expected return on plan assets	(306)	(252)	(604)	(504)
Amortization of prior service cost	—	—	—	—
Amortization of net loss	—	95	—	95
Net periodic (benefit) expense	$(113)	$ 18	$(218)	$(59)

Note 10. Other Comprehensive Income (Loss)

Accounting principles generally require recognized revenue, expenses, gains and losses be included in net income or loss. Certain changes in assets and liabilities, such as the after tax effect of unrealized gains and losses on investment securities AFS that are not OTTI and the unfunded liability for the defined benefit pension plan, are not reflected in the consolidated statement of income. The cumulative effect of such items, net of tax effect, is reported as a separate component of the equity section of the consolidated balance sheet (Accumulated OCI). OCI, along with net income, comprises the Company's total comprehensive income or loss.

As of the balance sheet dates, the components of Accumulated OCI, net of tax, were:

	June 30, 2014	December 31, 2013
	(Dollars in thousands)	
Net unrealized gain (loss) on investment securities available-for-sale	$188	$(513)
Defined benefit pension plan net unrealized actuarial gain	590	590
Total	$778	$77

The following table discloses the tax effects allocated to each component of OCI for the three months ended June 30:

	Three Months Ended					
	June 30, 2014			June 30, 2013		
	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
	(Dollars in thousands)					
Investment securities available-for-sale:						
Net unrealized holding gains (losses) arising during the period on investment securities available-for-sale	$541	$(184)	$357	$(936)	$318	$(618)
Reclassification adjustment for net (gains) losses on investment securities available-for-sale realized in net income	(19)	6	(13)	4	(1)	3
Total	522	(178)	344	(932)	317	(615)
Defined benefit pension plan:						
Reclassification adjustment for amortization of net actuarial loss realized in net income	—	—	—	95	(32)	63
Total other comprehensive income (loss)	$522	$(178)	$344	$(837)	$285	$(552)

The following table discloses the tax effects allocated to each component of OCI for the six months ended June 30:

	Six Months Ended					
	June 30, 2014			June 30, 2013		
	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
	(Dollars in thousands)					
Investment securities available-for-sale:						
Net unrealized holding gains (losses) arising during the period on investment securities available-for-sale	$1,124	$(382)	$742	$(922)	$313	$(609)
Reclassification adjustment for net (gains) losses on investment securities available-for-sale realized in net income	(62)	21	(41)	1	—	1
Total	1,062	(361)	701	(921)	313	(608)
Defined benefit pension plan:						
Net actuarial loss arising during the period	—	—	—	(49)	16	(33)
Reclassification adjustment for amortization of net actuarial loss realized in net income	—	—	—	95	(32)	63
Total	—	—	—	46	(16)	30
Total other comprehensive income (loss)	$1,062	$(361)	$701	$(875)	$297	$(578)

The following table discloses information concerning the reclassification adjustments from OCI for the three and six months ended June 30:

Reclassification Adjustment Description	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013	Affected Line Item in Consolidated Statement of Income
	(Dollars in thousands)				
Investment securities available-for-sale:					
Net (gains) losses on investment securities available-for-sale	$(19)	$4	$(62)	$1	Net gains (losses) on sales of investment securities available-for-sale
Tax benefit (expense)	6	(1)	21	—	Provision for income taxes
	(13)	3	(41)	1	Net income
Defined benefit pension plan:					
Net actuarial loss	—	95	—	95	Pension and employee benefits
Tax expense	—	(32)	—	(32)	Provision for income taxes
	—	63	—	63	Net income
Total reclassifications	$(13)	$66	$(41)	$64	Net income

Note 11. Fair Value Measurements and Disclosures

The Company utilizes FASB ASC Topic 820, Fair Value Measurements and Disclosures, as guidance for accounting for assets and liabilities carried at fair value. This standard defines fair value as the price that would be received, without adjustment for transaction costs, to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is a market based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. The guidance in FASB ASC Topic 820 establishes a three-level fair value hierarchy, which prioritizes the inputs used in measuring fair value. A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The three levels of the fair value hierarchy are:

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

The following is a description of the valuation methodologies used for the Company's assets that are measured on a recurring basis at estimated fair value:

AFS securities: Marketable equity securities and mutual funds have been valued using unadjusted quoted prices from active markets and therefore have been classified as Level 1. However, the majority of the Company's AFS securities have been valued utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows.

Assets measured at fair value on a recurring basis at June 30, 2014 and December 31, 2013, segregated by fair value hierarchy level, are summarized below:

	Fair Value Measurements			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)			
June 30, 2014:				
Investment securities available-for-sale (market approach)				
Debt securities:				
U.S. Government-sponsored enterprises	$11,540	$—	$11,540	$—
Agency mortgage-backed	5,915	—	5,915	—
State and political subdivisions	15,048	—	15,048	—
Corporate	6,503	—	6,503	—
Total debt securities	39,006	—	39,006	—
Marketable equity securities	1,078	1,078	—	—
Mutual funds	275	275	—	—
Total	$40,359	$1,353	$39,006	$—
December 31, 2013:				
Investment securities available-for-sale (market approach)				
Debt securities:				
U.S. Government-sponsored enterprises	$13,237	$—	$13,237	$—
Agency mortgage-backed	3,747	—	3,747	—
State and political subdivisions	12,164	—	12,164	—
Corporate	3,834	1,436	2,398	—
Total debt securities	32,982	1,436	31,546	—
Marketable equity securities	1,041	1,041	—	—
Mutual funds	258	258	—	—
Total	$34,281	$2,735	$31,546	$—

There were no significant transfers in or out of Levels 1 and 2 for the three and six months. Certain other assets and liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Assets and liabilities measured at fair value on a nonrecurring basis in periods after initial recognition, such as impaired loans, HTM securities, MSRs and OREO, were not considered material at June 30, 2014 or December 31, 2013. The Company has not elected to apply the fair value method to any financial assets or liabilities other than those situations where other accounting pronouncements require fair value measurements.

FASB ASC Topic 825, Financial Instruments, requires disclosure of the estimated fair value of financial instruments. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company’s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Management’s estimates and assumptions are inherently subjective and involve uncertainties and matters of significant judgment. Changes in assumptions could dramatically affect the estimated fair values.

Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments may be excluded from disclosure requirements. Thus, the aggregate fair value amounts presented may not necessarily represent the actual underlying fair value of such instruments of the Company.

The following methods and assumptions were used by the Company in estimating the fair value of its significant financial instruments:

Cash and cash equivalents: The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values and are classified as Level 1.

Interest bearing deposits in banks: Fair values for interest bearing deposits in banks are based on discounted present values of cash flows and are classified as Level 2.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair value measurements consider observable data which may include market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows. Investment securities are classified as Level 1 or Level 2 depending on availability of recent trade information.

Loans held for sale: The fair value of loans held for sale is estimated based on quotes from third party vendors, resulting in a Level 2 classification.

Loans: The fair values of loans are estimated for portfolios of loans with similar financial characteristics and segregated by loan class or segment. For variable-rate loan categories that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts adjusted for credit risk. The fair values for other loans (for example, fixed-rate residential, commercial real estate, and rental property mortgage loans as well as commercial and industrial loans) are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future cash flows, future expected loss experience and risk characteristics. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable. The fair value methods and assumptions that utilize unobservable inputs as defined by current accounting standards are classified as Level 3.

Accrued interest receivable and payable: The carrying amounts of accrued interest approximate their fair values and are classified as Level 1, 2, or 3 in accordance with the classification of the related principal's valuation.

Nonmarketable equity securities: It is not practical to determine the fair value of the nonmarketable securities, such as FHLB stock, due to restrictions placed on their transferability.

Deposits: The fair values disclosed for noninterest bearing deposits are, by definition, equal to the amount payable on demand at the reporting date, resulting in a Level 1 classification. The fair values for time deposits and other interest bearing nontime deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar deposits to a schedule of aggregated expected maturities on such deposits, resulting in a Level 2 classification.

Borrowed funds: The fair values of the Company’s long-term debt are estimated using discounted cash flow analysis based on interest rates currently being offered on similar debt instruments, resulting in a Level 2 classification. The fair values of the Company’s short-term debt approximate the carrying amounts reported in the balance sheet, resulting in a Level 1 classification.

Off-balance-sheet financial instruments: Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The only commitments to extend credit that are normally longer than one year in duration are the home equity lines whose interest rates are variable quarterly. The only fees collected for commitments are an annual fee on credit card arrangements and often a flat fee on commercial lines of credit and standby letters of credit. The fair value of off-balance-sheet financial instruments as of the balance sheet dates was not significant.

As of the balance sheet dates, the estimated fair values and related carrying amounts of the Company's significant financial instruments were as follows:

	June 30, 2014				
	Fair Value Measurements				
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)				
Financial assets					
Cash and cash equivalents	$19,644	$19,644	$19,644	$—	$—
Interest bearing deposits in banks	13,713	13,767	—	13,767	—
Investment securities	50,001	49,654	1,353	48,301	—
Loans held for sale	6,662	6,813	—	6,813	—
Loans, net					
Residential real estate	159,488	166,253	—	—	166,253
Construction real estate	31,383	31,514	—	—	31,514
Commercial real estate	215,914	220,911	—	—	220,911
Commercial	23,070	22,397	—	—	22,397
Consumer	4,473	4,449	—	—	4,449
Municipal	16,645	17,813	—	—	17,813
Accrued interest receivable	1,741	1,741	—	291	1,450
Nonmarketable equity securities	2,053	N/A	N/A	N/A	N/A
Financial liabilities					
Deposits					
Noninterest bearing	$81,140	$81,140	$81,140	$—	$—
Interest bearing	290,980	290,990	—	290,990	—
Time	118,736	118,607	—	118,607	—
Borrowed funds					
Short-term	13,109	13,109	13,109	—	—
Long-term	11,650	12,448	—	12,448	—
Accrued interest payable	93	93	—	93	—

	December 31, 2013 Fair Value Measurements				
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(Dollars in thousands)				
Financial assets					
Cash and cash equivalents	$30,719	$30,719	$30,719	$—	$—
Interest bearing deposits in banks	17,613	17,721	—	17,721	—
Investment securities	45,492	44,645	2,735	41,910	—
Loans held for sale	3,840	3,905	—	3,905	—
Loans, net					
Residential real estate	158,249	165,475	—	—	165,475
Construction real estate	30,519	30,675	—	—	30,675
Commercial real estate	208,011	212,834	—	—	212,834
Commercial	20,413	19,751	—	—	19,751
Consumer	5,375	5,387	—	—	5,387
Municipal	34,069	34,648	—	—	34,648
Accrued interest receivable	1,663	1,663	4	262	1,397
Nonmarketable equity securities	2,053	N/A	N/A	N/A	N/A
Financial liabilities					
Deposits					
Noninterest bearing	$87,247	$87,247	$87,247	$—	$—
Interest bearing	269,614	269,614	—	269,614	—
Time	161,493	161,640	—	161,640	—
Borrowed funds					
Short-term	1,390	1,390	1,390	—	—
Long-term	11,826	12,649	—	12,649	—
Accrued interest payable	295	295	—	295	—

The carrying amounts in the preceding tables are included in the balance sheet under the applicable captions.

Note 12. Subsequent Events

Subsequent events represent events or transactions occurring after the balance sheet date but before the financial statements are issued. Financial statements are considered “issued” when they are widely distributed to shareholders and others for general use and reliance in a form and format that complies with GAAP. Events occurring subsequent to June 30, 2014 have been evaluated as to their potential impact to the consolidated financial statements.

On July 16, 2014, the Company declared a regular quarterly cash dividend of $0.26 per share, payable August 7, 2014, to stockholders of record on July 26, 2014.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

The following discussion and analysis focuses on those factors that, in management's view, had a material effect on the financial position of the Company as of June 30, 2014 and December 31, 2013, and its results of operations for the three and six months ended June 30, 2014 and 2013. This discussion is being presented to provide a narrative explanation of the consolidated financial statements and should be read in conjunction with the consolidated financial statements and related notes and with other financial data appearing elsewhere in this filing and with the Company's Annual Report on Form 10-K for the year ended December 31, 2013. In the opinion of the Company's management, the interim unaudited data reflects all adjustments, consisting only of normal recurring adjustments, and disclosures necessary to fairly present the Company's consolidated financial position and results of operations for the interim periods presented. Management is not aware of the occurrence of any events after June 30, 2014 which would materially affect the information presented.

Please refer to Note 1 in the Company's unaudited interim consolidated financial statements at Part I, Item 1 of this Report for definitions of acronyms, abbreviations and capitalized terms used throughout the following discussion and analysis.

CAUTIONARY ADVICE ABOUT FORWARD LOOKING STATEMENTS
The Company may from time to time make written or oral statements that are considered “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may include financial projections, statements of plans and objectives for future operations, estimates of future economic performance or conditions and assumptions relating thereto. The Company may include forward-looking statements in its filings with the SEC, in its reports to stockholders, including this quarterly report, in press releases, other written materials, and in statements made by senior management to analysts, rating agencies, institutional investors, representatives of the media and others.

Forward-looking statements reflect management's current expectations and are subject to uncertainties, both general and specific, and risk exists that actual results will differ from those predictions, forecasts, projections and other estimates contained in forward-looking statements. These risks cannot be readily quantified. When management uses any of the words “believes,” “expects,” “anticipates,” “intends,” "projects," “plans,” “seeks,” “estimates,” "targets," "goals," “n "might," “could,” “would,” “should,” or similar expressions, they are making forward-looking statements. Many possible events or factors, including those beyond the control of management, could affect the future financial results and performance of the Company.

Factors that may cause results or performance to differ materially from those expressed in forward-looking statements include, but are not limited to: (1) continuing general economic conditions and financial instability, either nationally, internationally, regionally or locally resulting from elevated unemployment rates, changes in monetary and fiscal policies, and adverse changes in the credit rating of U.S. government debt; (2) increased competitive pressures from tax-advantaged credit unions and other financial service providers in the Company's northern Vermont and northwestern New Hampshire market area or in the financial services industry generally, from increasing consolidation and integration of financial service providers, and from changes in technology and delivery systems; (3) interest rates change in such a way that continues to put pressure on the Company's margins, or result in lower fee income and lower gain on sale of real estate loans; (4) changes in laws or government rules, or the way in which courts or government agencies interpret or implement those laws or rules, that increase our costs of doing business or otherwise adversely affect the Company's business; (5) changes in federal or state tax policy; (6) the effect of federal and state health care reform efforts; (7) changes in the level of nonperforming assets and charge-offs; (8) changes in estimates of future reserve requirements based upon relevant regulatory and accounting requirements; (9) changes in information technology that require increased capital spending; (10) changes in consumer and business spending, borrowing and savings habits; (11) further changes to the calculation of the Company’s regulatory capital ratios which, among other things, would require additional regulatory capital, change the framework for risk-weighting of assets and require accumulated other comprehensive income to be reflected in regulatory capital; and (12) the effect of and changes in the United States monetary and fiscal policies, including interest rate policies and regulation of the money supply by the FRB.

When evaluating forward-looking statements to make decisions with respect to the Company, investors and others are cautioned to consider these and other risks and uncertainties, and are reminded not to place undue reliance on such statements. Investors should not consider the foregoing list of factors to be a complete list of risks or uncertainties. Forward-looking statements speak only as of the date they are made and the Company undertakes no obligation to update them to reflect new or changed information or events, except as may be required by federal securities laws.

CRITICAL ACCOUNTING POLICIES

The Company has established various accounting policies which govern the application of GAAP in the preparation of the Company's consolidated financial statements. Certain accounting policies involve significant judgments and assumptions by management which have a material impact on the reported amount of assets, liabilities, capital, revenues and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require management to make its most difficult and subjective judgments, often as a result of the need to make estimates on matters that are inherently uncertain. Based on this definition, management has identified the accounting policies and judgments most critical to the Company. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from estimates and have a material impact on the carrying value of assets, liabilities, or capital, and/or the results of operations of the Company.

Please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2013 for a more in-depth discussion of the Company's critical accounting policies. There have been no changes to the Company's critical accounting policies since the filing of that report.

OVERVIEW

The Company's net income was $1.9 million for the quarter ended June 30, 2014 compared to $1.8 million for the quarter ended June 30, 2013, an increase of $122 thousand, or 6.8%. These results reflected the net effect of an increase in net interest income of $189 thousand, or 3.5%, partially offset by a decrease in noninterest income of $10 thousand, or 0.5%, an increase in noninterest expenses of $48 thousand, or 0.9%, and an increase in the provision for income taxes of $9 thousand.

Total interest income increased $105 thousand, or 1.7%, to $6.2 million for the second quarter of 2014, versus $6.1 million for the second quarter of 2013, while interest expense decreased $84 thousand, or 13.7%, from $613 thousand for the second quarter of 2013 to $529 thousand for the second quarter of 2014. These changes in interest income and interest expense resulted in net interest income of $5.7 million for the second quarter of 2014, up $189 thousand, or 3.5%, from the second quarter of 2013 of $5.5 million.

Noninterest income decreased $10 thousand, or 0.5%, for the quarter due to lower net gains on sales of loans held for sale, which decreased $75 thousand, or 12.9%, from $583 thousand for the quarter ended June 30, 2013 to $508 thousand for the quarter ended June 30, 2014. The decrease in net gains was a result of a decrease in the volume of residential loans sold to the secondary market from $32.5 million in the second quarter of 2013 to $22.2 million in the second quarter of 2014, a decrease of $10.4 million, or 31.8%. The decrease in net gains on sales of loans for the quarter was partially offset by an increase in service fees of $28 thousand, or 2.2%, between periods, an increase in gains on sales of investment securities available-for-sale of $23 thousand and an increase of $37 thousand in trust income.

Noninterest expenses increased $48 thousand, or 0.9%, for the three month period ended June 30, 2014 compared to the same period for 2013, resulting from an increase in pension and employee benefits of $65 thousand, or 10.2%, an increase in equipment expense of $22 thousand, or 5.7%, partially offset by a decrease in salaries and wages of $41 thousand, or 1.8%.

Year to date earnings for 2014 were $3.7 million, or $0.83 per share, compared to $3.5 million, or $0.79 per share, for 2013, an increase of 4.2% year over year. Net interest income improved $435 thousand, or 4.0%. This positive change was partially offset by an increase in the provision for loan losses of $15 thousand, or 11.1%, a decrease in noninterest income of $203 thousand, or 4.7%, an increase in noninterest expense of $58 thousand and an increase in the provision for income taxes of $10 thousand.

At June 30, 2014, the Company had total consolidated assets of $571.5 million, including gross loans and loans held for sale (total loans) of $462.0 million, deposits of $490.9 million, borrowed funds of $24.8 million and stockholders' equity of $51.9 million. The Company’s total assets decreased $14.0 million, or 2.4%, from $585.4 million at December 31, 2013. The decrease in total assets is the result of a decrease in net loans and loans held for sale of $2.8 million, a decrease in cash and cash equivalents of $11.1 million and a decrease in interest bearing deposits in banks of $3.9 million, while investment securities increased $4.5 million compared to levels at December 31, 2013.

Net loans and loans held for sale decreased $2.8 million, or 0.6%, to $457.6 million, or 80.1% of total assets, at June 30, 2014, compared to $460.5 million, or 78.7% of total assets, at December 31, 2013. Although there was growth of $15.4 million in the residential, construction, commercial real estate and commercial loan portfolios during the first half of 2014, this was offset by a decrease of $17.4 million in the municipal loan portfolio, reflecting a one day seasonal fluctuation due to the municipal funding requirements in Vermont where municipalities and school districts utilize their deposits to pay down their annual line of credit prior to their June 30 fiscal year end.

Deposits decreased $27.5 million, or 5.3%, from $518.4 million at December 31, 2013 to $490.9 million at June 30, 2014 primarily as a result of the seasonal fluctuation related to the municipal funding cycle as municipalities utilize deposit monies to paydown outstanding loan balances as discussed above.

The Company's total capital increased from $49.8 million at December 31, 2013 to $51.9 million at June 30, 2014. While continuing to meet the regulatory guidelines for the well capitalized capital category, the total risk based capital ratio increased slightly to

13.37% at June 30, 2014 from 13.28% at December 31, 2013. The regulatory guideline for well capitalized is 10.0% and the minimum requirement is 8.0%.

The following unaudited per share information and key ratios depict several measurements of performance or financial condition for the three and six months ended June 30, 2014 and 2013, respectively:

	Three Months Ended or At June 30,		Six Months Ended or At June 30,	
	2014	2013	2014	2013
Return on average assets (ROA) (1)	1.31 %	1.27 %	1.26 %	1.25 %
Return on average equity (1)	15.01 %	15.65 %	14.55 %	15.51 %
Net interest margin (1)(2)	4.22 %	4.25 %	4.21 %	4.20 %
Efficiency ratio (3)	66.33 %	68.57 %	67.17 %	67.72 %
Net interest spread (4)	4.13 %	4.15 %	4.12 %	4.10 %
Loan to deposit ratio	94.12 %	94.77 %	94.12 %	94.77 %
Net loan charge-offs to average loans not held for sale (1)	0.14 %	0.03 %	0.08 %	0.02 %
Allowance for loan losses to loans not held for sale (5)	1.01 %	1.07 %	1.01 %	1.07 %
Nonperforming assets to total assets (6)	0.53 %	0.67 %	0.53 %	0.67 %
Equity to assets	9.08 %	8.38 %	9.08 %	8.38 %
Total capital to risk weighted assets	13.37 %	13.19 %	13.37 %	13.19 %
Book value per share	$11.64	$10.27	$11.64	$10.27
Earnings per share	$0.43	$0.40	$0.83	$0.79
Dividends paid per share	$0.26	$0.25	$0.52	$0.50
Dividend payout ratio (7)	60.47 %	62.50 %	62.65 %	63.29 %

(1) Annualized.

(2) The ratio of tax equivalent net interest income to average earning assets. See pages 30 and 31 for more information.

(3) The ratio of noninterest expense ($5.3 million in 2014 and $5.2 million in 2013) to tax equivalent net interest income ($5.9 million in 2014 and $5.6 million in 2013) and noninterest income ($2.1 million in 2014 and 2013) excluding securities gains (losses) ($19 thousand in 2014 and $(4) thousand in 2013) for the three months ended June 30, 2014 and 2013, respectively.

The ratio of noninterest expense ($10.5 million in 2014 and $10.4 million in 2013) to tax equivalent net interest income ($11.6 million in 2014 and $11.1 million in 2013) and noninterest income ($4.0 million in 2014 and $4.3 million in 2013) excluding securities gains (losses) ($62 thousand in 2014 and $(1) thousand in 2013) for the six months ended June 30, 2014 and 2013, respectively.

(4) The difference between the average rate earned on earning assets and the average rate paid on interest bearing liabilities. See pages 30 and 31 for more information.

(5) Calculation includes the net carrying amount of loans recorded at fair value from the 2011 Branch Acquisition as of June 30, 2014 ($16.5 million) and June 30, 2013 ($19.3 million). Excluding such loans, the allowance for loan losses to loans not purchased and not held for sale was 1.05% at June 30, 2014 and 1.12% at June 30, 2013.

(6) Nonperforming assets are loans or investment securities that are in nonaccrual or 90 or more days past due as well as OREO or OAO.

(7) Cash dividends declared and paid per share divided by consolidated net income per share.

RESULTS OF OPERATIONS

Net Interest Income. The largest component of the Company’s operating income is net interest income, which is the difference between interest and dividend income received from interest earning assets and the interest expense paid on interest bearing liabilities. The Company’s net interest income increased $189 thousand, or 3.5%, to $5.7 million for the three months ended June 30, 2014 from $5.5 million for the three months ended June 30, 2013. The net interest spread decreased 2 bps to 4.13% for the second quarter of 2014, from 4.15% for the same period last year, despite a 9 bps drop in the average interest rate paid on interest bearing liabilities, from 0.56% for the second quarter of 2013 to 0.47% for the second quarter of 2014, as the average yield earned on interest earning assets dropped 11 bps, from 4.71% for the three months ended June 30, 2013 to 4.60% for the three month period ended June 30, 2014. The net interest margin for the second quarter of 2014 decreased 3 bps to 4.22% from 4.25% for the second quarter of 2013. The prolonged low rate environment continues to put pressure on the Company's net interest spread and margin.

Yields Earned and Rates Paid. The following tables show for the periods indicated the total amount of income recorded from average interest earning assets, the related average tax equivalent yields, the interest expense associated with average interest bearing liabilities, the related average rates paid, and the resulting tax equivalent net interest spread and margin. Yield and rate information is average information for the period, and is calculated by dividing the annualized tax equivalent income or expense item for the period by the average balance of the appropriate balance sheet item during the period. Net interest margin is annualized tax equivalent net interest income divided by average earning assets. Nonaccrual loans or investments are included in asset balances for the appropriate periods, but recognition of interest on such loans or investments is discontinued and any remaining accrued interest receivable is reversed in conformity with federal regulations.

	Three months Ended June 30,							
	2014				2013			
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate		Average Balance	Interest Earned/ Paid	Average Yield/ Rate	
	(Dollars in thousands)							
Average Assets:								
Federal funds sold and overnight deposits	$11,585	$4	0.13	%	$16,670	$10	0.25	%
Interest bearing deposits in banks	14,540	39	1.06	%	22,624	59	1.05	%
Investment securities (1), (2)	52,596	306	2.65	%	36,704	221	2.76	%
Loans, net (1), (3)	475,582	5,828	5.05	%	453,798	5,787	5.23	%
Nonmarketable equity securities	2,053	7	1.45	%	1,811	2	0.44	%
Total interest earning assets (1)	556,356	6,184	4.60	%	531,607	6,079	4.71	%
Cash and due from banks	4,300				4,390			
Premises and equipment	10,957				10,283			
Other assets	14,832				19,385			
Total assets	$586,445				$565,665			
Average Liabilities and Stockholders' Equity:								
Interest bearing checking accounts	$103,438	$20	0.08	%	$90,975	$20	0.09	%
Savings/money market accounts	184,458	79	0.17	%	179,839	90	0.20	%
Time deposits	143,840	322	0.90	%	146,358	376	1.03	%
Borrowed funds	18,324	108	2.34	%	16,913	127	2.97	%
Total interest bearing liabilities	450,060	529	0.47	%	434,085	613	0.56	%
Noninterest bearing deposits	84,372				80,038			
Other liabilities	851				5,619			
Total liabilities	535,283				519,742			
Stockholders' equity	51,162				45,923			
Total liabilities and stockholders’ equity	$586,445				$565,665			
Net interest income		$5,655				$5,466		
Net interest spread (1)			4.13	%			4.15	%
Net interest margin (1)			4.22	%			4.25	%

(1) Average yields reported on a tax equivalent basis using a marginal tax rate of 34%.

(2) Average balances of investment securities are calculated on the amortized cost basis and include nonaccrual securities, if applicable.

(3) Includes loans held for sale as well as nonaccrual loans, unamortized costs and unamortized premiums and is net of the allowance for loan losses.

	Six Months Ended June 30,							
	2014				2013			
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate		Average Balance	Interest Earned/ Paid	Average Yield/ Rate	
	(Dollars in thousands)							
Average Assets:								
Federal funds sold and overnight deposits	$12,335	$8	0.13	%	$22,244	$23	0.21	%
Interest bearing deposits in banks	15,811	84	1.07	%	22,635	119	1.06	%
Investment securities (1), (2)	51,227	599	2.65	%	33,004	415	2.92	%
Loans, net (1), (3)	471,563	11,590	5.08	%	451,693	11,455	5.23	%
Nonmarketable equity securities	2,053	15	1.46	%	1,873	4	0.41	%
Total interest earning assets (1)	552,989	12,296	4.62	%	531,449	12,016	4.68	%
Cash and due from banks	4,503				4,581			
Premises and equipment	10,864				10,294			
Other assets	15,427				19,539			
Total assets	$583,783				$565,863			
Average Liabilities and Stockholders' Equity:								
Interest bearing checking accounts	$100,505	$38	0.08	%	$90,856	$41	0.09	%
Savings/money market accounts	180,974	162	0.18	%	178,934	180	0.20	%
Time deposits	149,348	693	0.94	%	147,716	783	1.07	%
Borrowed funds	16,244	213	2.61	%	16,812	257	3.04	%
Total interest bearing liabilities	447,071	1,106	0.50	%	434,318	1,261	0.58	%
Noninterest bearing deposits	85,123				80,380			
Other liabilities	973				5,583			
Total liabilities	533,167				520,281			
Stockholders' equity	50,616				45,582			
Total liabilities and stockholders’ equity	$583,783				$565,863			
Net interest income		$11,190				$10,755		
Net interest spread (1)			4.12	%			4.10	%
Net interest margin (1)			4.21	%			4.20	%

(1) Average yields reported on a tax equivalent basis using a marginal tax rate of 34%.

(2) Average balances of investment securities are calculated on the amortized cost basis and include nonaccrual securities, if applicable.

(3) Includes loans held for sale as well as nonaccrual loans, unamortized costs and unamortized premiums and is net of the allowance for loan losses.

Tax exempt interest income amounted to $433 thousand and $364 thousand for the three months ended June 30, 2014 and 2013, respectively and $813 thousand and $713 thousand for the six months ended June 30, 2014 and 2013, respectively. The following table presents the effect of tax exempt income on the calculation of net interest income, using a marginal tax rate of 34% for 2014 and 2013:

	For The Three Months Ended June 30,		For The Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Net interest income as presented	$5,655	$5,466	$11,190	$10,755
Effect of tax-exempt interest				
Investment securities	43	33	81	67
Loans	154	132	289	258
Net interest income, tax equivalent	$5,852	$5,631	$11,560	$11,080

Rate/Volume Analysis. The following table describes the extent to which changes in average interest rates (on a fully tax-equivalent basis) and changes in volume of average interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. For each category of interest earning assets and interest bearing liabilities, information is provided on changes attributable to:

- changes in volume (change in volume multiplied by prior rate);
- changes in rate (change in rate multiplied by prior volume); and
- total change in rate and volume.

Changes attributable to both rate and volume have been allocated proportionately to the change due to volume and the change due to rate.

	Three Months Ended June 30, 2014 Compared to Three Months Ended June 30, 2013 Increase/(Decrease) Due to Change In			Six Months Ended June 30, 2014 Compared to Six Months Ended June 30, 2013 Increase/(Decrease) Due to Change In		
	Volume	Rate	Net	Volume	Rate	Net
	(Dollars in thousands)					
Interest earning assets:						
Federal funds sold and overnight deposits	$(2)	$(4)	$(6)	$(8)	$(7)	$(15)
Interest bearing deposits in banks	(21)	1	(20)	(36)	1	(35)
Investment securities	101	(16)	85	239	(55)	184
Loans, net	267	(226)	41	491	(356)	135
Nonmarketable equity securities	—	5	5	—	11	11
Total interest earning assets	$345	$(240)	$105	$686	$(406)	$280
Interest bearing liabilities:						
Interest bearing checking accounts	$3	$(3)	$—	$4	$(7)	$(3)
Savings/money market accounts	2	(13)	(11)	2	(20)	(18)
Time deposits	(6)	(48)	(54)	9	(99)	(90)
Borrowed funds	9	(28)	(19)	(9)	(35)	(44)
Total interest bearing liabilities	$8	$(92)	$(84)	$6	$(161)	$(155)
Net change in net interest income	$337	$(148)	$189	$680	$(245)	$435

Three Months Ended June 30, 2014, Compared to Three Months Ended June 30, 2013

Interest and Dividend Income. The Company’s interest and dividend income increased to $6.2 million for the three months ended June 30, 2014 compared to $6.1 million for the same period last year, driven by an overall increase in average earning assets of $24.7 million, or 4.7%, to $556.4 million, from $531.6 million for the three months ended June 30, 2013. However, the positive effect on interest income resulting from the rise in the average volume of earning assets was partially offset by the lower rates earned on all interest earning assets except nonmarketable equity securities and interest bearing deposits in banks. The persistent low interest rate environment resulted in lower yields earned on new earning assets or refinanced loans in the second quarter of 2014 versus 2013. Despite the lower yields, the second quarter of 2014 saw a slight increase in interest income on loans of $41 thousand, or 0.7%, compared to the second quarter of 2013, in conjunction with an increase in average loan volume between periods. Average loan volume approximated $475.6 million at an average yield of 5.05% for the three months ended June 30, 2014, up $21.8 million, or 4.8%, from an average volume of $453.8 million at an average yield of 5.23% for the three months ended June 30, 2013. The positive impact of the increase in average total loan volume was partially offset by an 18 bps decrease in average yield.

The average balance of nonloan instruments increased $3.0 million, or 3.8%, with the average balance of investments increasing $15.9 million, or 43.3%, to $52.6 million for the quarter ended June 30, 2014, from $36.7 million for the quarter ended June 30, 2013, partially offset by a decrease in federal funds sold and overnight deposits of $5.1 million, or