UNITY BANCORP INC /NJ/
Form 10-Q
August 12, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2011

OR

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

Commission file number 1-12431

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

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

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

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

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

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

The number of shares outstanding of each of the registrant's classes of common equity stock, as of August 1, 2011
common stock, no par value: 7,412,397 shares outstanding

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PART I - CONSOLIDATED FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.
Consolidated Balance Sheets
(Unaudited)

Amounts in thousands, except percentages	June 30, 2011	December 31, 2010	June 30, 2010
ASSETS			
Cash and due from banks	$ 12,915	$ 17,637	$ 18,016
Federal funds sold and interest-bearing deposits	33,367	26,289	37,478
Cash and cash equivalents	46,282	43,926	55,494
Securities:			
Securities available for sale, at fair value	101,872	107,131	121,628
Securities held to maturity (fair value of $13,855, $21,351, and $22,563, respectively)	13,316	21,111	22,034
Total securities	115,188	128,242	143,662
Loans:			
SBA loans held for sale	13,753	10,397	22,093
SBA loans held to maturity	71,429	75,741	73,298
SBA 504 loans	55,810	64,276	65,343
Commercial loans	287,785	281,205	285,173
Residential mortgage loans	134,782	128,400	132,993
Consumer loans	51,546	55,917	58,280
Total loans	615,105	615,936	637,180
Allowance for loan losses	(16,018)	(14,364)	(13,946)
Net loans	599,087	601,572	623,234
Premises and equipment, net	10,650	10,967	11,348
Bank owned life insurance (BOLI)	8,959	8,812	8,653
Deferred tax assets	6,756	7,550	7,485
Federal Home Loan Bank stock, at cost	4,088	4,206	4,656
Accrued interest receivable	3,692	3,791	3,972
Prepaid FDIC insurance	2,720	3,266	3,836
Other real estate owned (OREO)	2,722	2,346	3,728
Goodwill and other intangibles	1,537	1,544	1,552
Other assets	4,482	2,188	2,115
Total Assets	$ 806,163	$ 818,410	$ 869,735
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Deposits:			
Noninterest-bearing demand deposits	$ 94,547	$ 91,272	$ 87,908

Interest-bearing demand deposits		93,730		105,530	98,316
Savings deposits		285,651		277,394	291,355
Time deposits, under $100,000		106,880		119,478	143,617
Time deposits, $100,000 and over		60,359		61,114	72,036
Total deposits		641,167		654,788	693,232
Borrowed funds		75,000		75,000	87,672
Subordinated debentures		15,465		15,465	15,465
Accrued interest payable		570		556	661
Accrued expenses and other liabilities		1,754		2,516	3,072
Total liabilities		733,956		748,325	800,102
Commitments and contingencies		-		-	-
Shareholders' equity:					
Cumulative perpetual preferred stock		19,278		19,019	18,770
Common stock		53,590		55,884	55,592
Accumulated deficit		(1,757)		(772)	(815)
Treasury stock at cost		-		(4,169)	(4,169)
Accumulated other comprehensive income		1,096		123	255
Total Shareholders' Equity		72,207		70,085	69,633
Total Liabilities and Shareholders' Equity	$	806,163	$	818,410	$ 869,735
Preferred shares		21		21	21
Issued common shares		7,412		7,636	7,579
Outstanding common shares		7,412		7,211	7,154

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

Unity Bancorp
Consolidated Statements of Income
(Unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands, except per share amounts)	2011	2010	2011	2010
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	$ 9	$ 29	$ 20	$ 55
Federal Home Loan Bank stock	35	49	101	83
Securities:				
Available for sale	891	1,054	1,754	2,334
Held to maturity	180	250	468	588
Total securities	1,071	1,304	2,222	2,922
Loans:				
SBA loans	1,191	1,300	2,427	2,752
SBA 504 loans	834	1,091	1,789	2,177
Commercial loans	4,581	4,488	8,887	9,092
Residential mortgage loans	1,846	1,959	3,677	3,921
Consumer loans	629	724	1,315	1,455
Total loans	9,081	9,562	18,095	19,397
Total interest income	10,196	10,944	20,438	22,457
INTEREST EXPENSE				
Interest-bearing demand deposits	143	188	283	446
Savings deposits	584	728	1,165	1,629
Time deposits	1,045	1,687	2,140	3,500
Borrowed funds and subordinated debentures	953	1,078	1,904	2,155
Total interest expense	2,725	3,681	5,492	7,730
Net interest income	7,471	7,263	14,946	14,727
Provision for loan losses	1,750	1,500	4,250	3,000
Net interest income after provision for loan losses	5,721	5,763	10,696	11,727
NONINTEREST INCOME				
Branch fee income	337	331	680	692
Service and loan fee income	384	245	627	454
Gain on sale of SBA loans held for sale, net	399	147	510	147
Gain on sale of mortgage loans	87	112	256	258
Bank owned life insurance (BOLI)	74	78	147	151
Net security gains (losses)	(39)	4	87	8
Other income	205	253	395	370
Total noninterest income	1,447	1,170	2,702	2,080
NONINTEREST EXPENSE				
Compensation and benefits	2,880	2,822	5,937	5,821
Occupancy	827	608	1,546	1,285
Processing and communications	537	555	1,044	1,080
Furniture and equipment	410	447	794	870
Professional services	192	199	394	428

Loan collection costs		201		243		425		427
OREO expense		223		157		445		187
Deposit insurance		282		320		601		650
Advertising		205		241		323		348
Other expenses		490		448		897		885
Total noninterest expense		6,247		6,040		12,406		11,981
Income before provision for income taxes		921		893		992		1,826
Provision for income taxes		277		212		129		397
Net income		644		681		863		1,429
Preferred stock dividends & discount accretion		395		379		778		752
Income available to common shareholders	$	249	$	302	$	85	$	677
Net income per common share - Basic	$	0.03	$	0.04	$	0.01	$	0.09
- Diluted	$	0.03	$	0.04	$	0.01	$	0.09
Weighted average common shares outstanding - Basic		7,271		7,156		7,245		7,153
- Diluted		7,710		7,475		7,688		7,392

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

Unity Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2011 and 2010

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2009	$ 18,533	7,144	$ 55,454	$ (1,492)	$ (4,169)	$ (461)	$ 67,865
Comprehensive income:							
Net income				1,429			1,429
Net unrealized gains on securities						666	666
Net unrealized gains on cash flow hedge derivatives						50	50
Total comprehensive income							2,145
Accretion of discount on preferred stock	237			(237)			-
Dividends on preferred stock (5% annually)				(515)			(515)
Common stock issued and related tax effects (a)		10	138				138
Balance, June 30, 2010	$ 18,770	7,154	$ 55,592	$ (815)	$ (4,169)	$ 255	$ 69,633

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2010	$ 19,019	7,211	$ 55,884	$ (772)	$ (4,169)	$ 123	$ 70,085
Comprehensive income:							
Net income				863			863
Net unrealized gains on securities						814	814
Net unrealized gains on cash flow hedge derivatives						159	159
Total comprehensive income							1,836
Accretion of discount on preferred stock	259			(259)			-
Dividends on preferred stock (5% annually)				(521)			(521)
Retire Treasury stock			(3,101)	(1,068)	4,169		-

Common stock issued and related tax effects (a)		201	807				807
Balance, June 30, 2011	$ 19,278	7,412	$ 53,590	$ (1,757)	$ -	$ 1,096	$ 72,207

(a) Includes the issuance of common stock under employee benefit plans, which includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

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

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

	For the six months ended June 30,	
(In thousands)	2011	2010
OPERATING ACTIVITIES		
Net income	$ 863	$ 1,429
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	4,250	3,000
Net amortization of purchase premiums and discounts on securities	265	514
Depreciation and amortization	495	609
Deferred income tax expense (benefit)	147	(664)
Net security gains	(87)	(8)
Stock compensation expense	77	140
(Gain) Loss on sale of other real estate owned	(51)	4
Gain on sale of SBA loans held for sale, net	(510)	(147)
Gain on sale of mortgage loans	(256)	(258)
Origination of mortgage loans held for sale	(15,692)	(14,314)
Origination of SBA loans held for sale	(9,347)	(2,101)
Proceeds from sale of mortgage loans held for sale, net	15,948	14,572
Proceeds from sale of SBA loans held for sale, net	6,501	1,561
Loss on sale of premises and equipment	199	3
Net change in other assets and liabilities	(1,242)	1,587
Net cash provided by operating activities	1,560	5,927
INVESTING ACTIVITIES:		
Purchases of securities available for sale	(22,685)	(20,978)
Maturities and principal payments on securities held to maturity	5,606	4,179
Maturities and principal payments on securities available for sale	18,868	32,041
Proceeds from sale of securities held to maturity	2,168	1,893
Proceeds from sale of securities available for sale	10,273	8,838
Proceeds from sale of other real estate owned	306	1,954
Proceeds from redemption of Federal Home Loan Bank stock	118	21
Net decrease in loans	99	13,475
Purchase of bank owned life insurance	-	(2,500)
Proceeds from sale of premises and equipment	225	26
Purchases of premises and equipment	(488)	(207)
Net cash provided by investing activities	14,490	38,742
FINANCING ACTIVITIES:		
Net decrease in deposits	(13,621)	(65,007)
Proceeds from new borrowings	-	2,672
Proceeds from the exercise of stock options	443	41
Cash dividends paid on preferred stock	(516)	(516)

Net cash used in financing activities		(13,694)		(62,810)
Increase (decrease) in cash and cash equivalents		2,356		(18,141)
Cash and cash equivalents, beginning of period		43,926		73,635
Cash and cash equivalents, end of period	$	46,282	$	55,494
SUPPLEMENTAL DISCLOSURES:				
Cash:				
Interest paid	$	5,478	$	7,779
Income taxes paid		345		954
Noncash investing activities:				
Transfer of loans to other real estate owned		1,385		4,152

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

Unity Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)
June 30, 2011

NOTE 1. Significant Accounting Policies

The accompanying Consolidated Financial Statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank's investment portfolio. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation, with no impact on current earnings. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting periods. Actual results could differ from those estimates. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the consolidated financial statements included in this Quarterly Report on Form 10-Q were issued.

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses, the valuation of deferred income tax assets and the fair value of financial instruments. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC"). The results of operations for the six months ended June 30, 2011 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

Subsequent Events

During the quarter, the Company decided to close two of its underperforming branches. The Colonia, NJ branch will be closed on or about July 22, 2011. The Springfield, NJ branch will be closed on or about September 23, 2011. As a result of this decision, $215 thousand in residual lease and fixed asset disposal expenses were realized in the second quarter.

Stock Transactions

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

Stock Option Plans

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of June 30, 2011, 1,720,529 shares have been reserved for issuance upon the exercise of options, 584,388 option grants are outstanding, and 955,482 option grants have been exercised, forfeited or expired, leaving 180,659 shares available for grant.

The Company granted 67,000 options in 2011 as compared to no options in 2010. The fair value of the options granted in 2011 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2011		2010	
Number of options granted	67,000		-	
Weighted average exercise price	$6.66		$-	
Weighted average fair value of options	$3.20		$-	
Expected life (years)	4.62		-	
Expected volatility	57.69	%	-	%
Risk-free interest rate	1.28	%	-	%
Dividend yield	0.00	%	-	%

The expected life of the options was estimated based on historical employee behavior and represents the period of time that options granted are expected to be outstanding. Expected volatility of the Company's stock price was based on the historical volatility over the period commensurate with the expected life of the options. The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the date of grant. The expected dividend yield is the projected annual yield based on the grant date stock price.

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options totaled $26 thousand and $31 thousand for the three months ended June 30, 2011 and 2010, respectively. The related income tax benefit was approximately $9 thousand and $12 thousand for the three months ended June 30, 2011 and 2010, respectively. Compensation expense related to stock options totaled $46 thousand and $83 thousand for the six months ended June 30, 2011 and 2010, respectively. The related income tax benefit was approximately $17 thousand and $33 thousand for the six months ended June 30, 2011 and 2010, respectively. As of June 30, 2011, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately $277 thousand. That cost is expected to be recognized over a weighted average period of 2.5 years.

Transactions under the Company's stock option plans for the six months ended June 30, 2011 are summarized in the following table:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2010	775,468	$ 5.90	3.9	$ 1,049,184
Options granted	67,000	6.66		
Options exercised	(232,367)	3.39		

Options forfeited	(2,783)	7.25		
Options expired	(22,930)	9.71		
Outstanding at June 30, 2011	584,388	$ 6.83	5.3	$ 636,214
Exercisable at June 30, 2011	446,890	$ 7.30	4.2	$ 431,986

The following table summarizes information about stock options outstanding at June 30, 2011:

		Options Outstanding		Options Exercisable	
Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
$ 0.00 - 4.00	127,157	7.8	$ 3.87	66,661	$ 3.84
4.01 - 8.00	278,973	5.3	5.97	201,971	5.81
8.01 - 12.00	121,617	2.7	9.22	121,617	9.22
12.01 - 16.00	56,641	5.4	12.54	56,641	12.54
Total	584,388	5.3	$ 6.83	446,890	$ 7.30

The following table presents information about options exercised during the three and six months ended June 30, 2011 and 2010:

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Number of options exercised	191,895	667	232,367	12,406
Total intrinsic value of options exercised	$ 669,799	$ 627	$ 751,146	$ 16,399
Cash received from options exercised	440,541	2,921	442,905	34,652
Tax deduction realized from options exercised	262,223	-	294,713	6,299

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options.

Restricted Stock Awards

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value and amortized into salary expense on a straight line basis over the vesting period. As of June 30, 2011, 221,551 shares of restricted stock were reserved for issuance, of which 91,162 shares are available for grant.

Restricted stock awards granted during the past two years include:

Grant Year	Shares	Average Grant Date Fair Value
2011	22,500	$6.66
2010	-	$-

Compensation expense related to the restricted stock awards totaled $15 thousand and $22 thousand for the three months ended June 30, 2011 and 2010, respectively. Compensation expense related to the restricted stock awards totaled $31 thousand and $57 thousand for the six months ended June 30, 2011 and 2010, respectively. As of June 30, 2011, there was approximately $274 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 3.3 years.

The following table summarizes nonvested restricted stock activity for the six months ended June 30, 2011:

	Shares		Average Grant Date Fair Value
Nonvested restricted stock at December 31, 2010	43,367	$	5.83
Granted	22,500		6.66
Vested	(6,507)		10.91
Forfeited	(1,326)		8.72
Nonvested restricted stock at June 30, 2011	58,034	$	5.51

Income Taxes

The Company follows FASB ASC Topic 740, "Income Taxes," which prescribes a threshold for the financial statement recognition of income taxes and provides criteria for the measurement of tax positions taken or expected to be taken in a tax return. ASC 740 also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that ultimately would be sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. The evaluation of a tax position taken is considered by itself and not offset or aggregated with other positions. Tax positions that meet the more likely than not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits are recognized in income tax expense on the income statement.

Derivative Instruments and Hedging Activities

The Company uses derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. As of June 30, 2011, all of the Company's derivative instruments qualified as hedging instruments.

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

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

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

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

Loans Held To Maturity and Loans Held For Sale

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

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

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

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

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

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all troubled debt restructurings and nonperforming loans. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for other loans. Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider, such as a below market interest rate. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the paragraphs above. Impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Impairment can also be measured based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge or credit to the provision for loan losses.

Loans held for sale are SBA loans and are reflected at the lower of aggregate cost or market value. The net amount of loan origination fees on loans sold is included in the carrying value and in the gain or loss on the sale.

The Company originates loans to customers under an SBA program that generally provides for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. During late 2008, the Company withdrew from SBA lending outside of its primary trade area, but continues to offer SBA loan products as an additional credit product within its primary trade area. If sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income.

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

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

Allowance for Loan Losses and Unfunded Loan Commitments

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

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

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

The Company maintains an allowance for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the allowance are made through other expenses and applied to the allowance which is maintained in other liabilities.

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

Other-Than-Temporary Impairment

The Company has a process in place to identify debt securities that could potentially incur credit impairment that is other-than-temporary. This process involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. This evaluation considers relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other-than-temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) for fixed maturity securities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and for equity securities, our ability and intent to hold the security for a forecasted period of time that allows for the recovery in value.

Management assesses its intent to sell or whether it is more likely than not that it will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired with no intent to sell and no requirement to sell prior to recovery of its amortized cost basis, the amount of the impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income.

The present value of expected future cash flows is determined using the best estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds and structural support, including subordination and guarantees. The corporate bond cash flow estimates are derived from scenario-based outcomes of expected corporate restructurings or the disposition of assets using bond specific facts and circumstances including timing, security interests and loss severity.

NOTE 2. Litigation

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

NOTE 3. Net Income per Share

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

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

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

	Three months ended June 30,		Six months ended June 30,	
(In thousands, except per share amounts)	2011	2010	2011	2010
Net income	$ 644	$ 681	$ 863	$ 1,429
Less: Preferred stock dividends and discount accretion	395	379	778	752
Income available to common shareholders	$ 249	$ 302	$ 85	$ 677
Weighted average common shares outstanding - Basic	7,271	7,156	7,245	7,153
Plus: Potential dilutive common stock equivalents	439	319	443	239
Weighted average common shares outstanding - Diluted	7,710	7,475	7,688	7,392
Net income per common share -				
Basic	$ 0.03	$ 0.04	$ 0.01	$ 0.09
Diluted	0.03	0.04	0.01	0.09
Stock options and common stock excluded from the income per share computation as their effect would have been anti-dilutive	385	566	386	750

The "potential dilutive common stock equivalents" and the "stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive" shown in the table above include the impact of 764,778 common stock warrants issued to the U.S. Department of Treasury under the Capital Purchase Program in December 2008. These warrants were dilutive for the three and six months ended June 30, 2011.

NOTE 4. Income Taxes

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

The Company did not recognize or accrue any interest or penalties related to income taxes during the six months ended June 30, 2011 and 2010. The Company does not have an accrual for uncertain tax positions as of June 30, 2011 or December 31, 2010, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2007 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive Income (Loss)

Changes in Other Comprehensive Income (Loss) for the six months ended June 30, 2011 and 2010:

(In thousands)	Pre-tax	Tax	After-tax
Net unrealized gains (losses) on securities:			
Balance at December 31, 2009			$ 5
Unrealized holding gain on securities arising during the period	$ 1,127	$ 456	671
Less: Reclassification adjustment for gains included in net income	8	3	5
Net unrealized gain on securities arising during the period	1,119	453	666
Balance at June 30, 2010			$ 671
Balance at December 31, 2010			$ 423
Unrealized holding gain on securities arising during the period	$1,442	$570	872
Less: Reclassification adjustment for gains included in net income	87	29	58
Net unrealized gain on securities arising during the period	1,355	541	814
Balance at June 30, 2011			$1,237
Net unrealized gains (losses) on cash flow hedges:			
Balance at December 31, 2009			$ (466)
Unrealized holding gain on cash flow hedges arising during the period	$ 83	$ 33	50
Balance at June 30, 2010			$ (416)
Balance at December 31, 2010			$ (300)
Unrealized holding gain on cash flow hedges arising during the period	$ 263	$ 104	159
Balance at June 30, 2011			$ (141)
Total Accumulated Other Comprehensive Income at June 30, 2011			$ 1,096

Changes in Other Comprehensive Income (Loss) for the three months ended June 30, 2011 and 2010:

(In thousands)	Pre-tax	Tax	After-tax
Net unrealized gains (losses) on securities:			
Balance at March 31, 2010			$ 277
Unrealized holding gain on securities arising during the period	$ 659	$ 263	396
Less: Reclassification adjustment for gains included in net income	4	2	2
Net unrealized gain on securities arising during the period	655	261	394
Balance at June 30, 2010			$ 671
Balance at March 31, 2011			$ 615
Unrealized holding gain on securities arising during the period	$996	$399	597
Less: Reclassification adjustment for losses included in net income	(38)	(13)	(25)
Net unrealized gain on securities arising during the period	1,034	412	622
Balance at June 30, 2011			$1,237
Net unrealized gains (losses) on cash flow hedges:			
Balance at March 31, 2010			$ (465)
Unrealized holding gain on cash flow hedges arising during the period	$ 82	$ 33	49
Balance at June 30, 2010			$ (416)
Balance at March 31, 2011			$ (216)
Unrealized holding gain on cash flow hedges arising during the period	$ 124	$ 49	75
Balance at June 30, 2011			$ (141)
Total Accumulated Other Comprehensive Income at June 30, 2011			$ 1,096

NOTE 6. Fair Value

Fair Value Measurement

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

Level 1 Inputs

- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Generally, this includes debt and equity securities and derivative contracts that are traded in an active exchange market (i.e. New York Stock Exchange), as well as certain U.S. Treasury, U.S. Government and sponsored entity agency mortgage-backed securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Inputs

- Quoted prices for similar assets or liabilities in active markets.
- Quoted prices for identical or similar assets or liabilities in inactive markets.
- Inputs other than quoted prices that are observable, either directly or indirectly, for the term of the asset or liability (i.e., interest rates, yield curves, credit risks, prepayment speeds or volatilities) or “market corroborated inputs.”
- Generally, this includes U.S. Government and sponsored entity mortgage-backed securities, corporate debt securities and derivative contracts.

Level 3 Inputs

- Prices or valuation techniques that require inputs that are both unobservable (i.e. supported by little or no market activity) and that are significant to the fair value of the assets or liabilities.
- These assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair Value on a Recurring Basis

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

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

As of June 30, 2011, the fair value of the Company's AFS securities portfolio was $101.9 million. Approximately 75 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $76.0 million at June 30, 2011. Approximately $72.7 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States. All AFS securities were classified as Level 2 assets at June 30, 2011. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

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

There were no changes in the inputs or methodologies used to determine fair value during the period ended June 30, 2011 as compared to the period ended December 31, 2010 and June 30, 2010. The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2011 and December 31, 2010.

		As of June 30, 2011		
(In thousands)	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	$ -	$ 8,479	$ -	$ 8,479
State and political subdivisions	-	11,567	-	11,567
Residential mortgage-backed securities	-	76,012	-	76,012
Commercial mortgage-backed securities	-	1,479	-	1,479
Trust preferred securities	-	749	-	749
Other equities	-	3,586	-	3,586
Total securities available for sale	-	101,872	-	101,872
Financial Liabilities:				
Interest rate swap agreements	-	236	-	236

As of December 31, 2010

(In thousands)	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	$ -	$ 6,462	$ -	$ 6,462
State and political subdivisions	-	10,963	-	10,963
Residential mortgage-backed securities	-	85,741	-	85,741
Commercial mortgage-backed securities	-	1,826	-	1,826
Trust preferred securities	-	565	-	565
Other equities	-	1,574	-	1,574
Total securities available for sale	-	107,131	-	107,131
Financial Liabilities:				
Interest rate swap agreements	-	499	-	499

The changes in Level 2 assets and liabilities measured at fair value on a recurring basis as of June 30, 2011 are summarized as follows:

	As of June 30, 2011	
(In thousands)	Securities Available for Sale	Interest Rate Swap Agreements
Beginning balance December 31, 2010	$ 107,131	$ 499
Total net gains (losses) included in:		
Net income	155	-
Other comprehensive income	1,355	(263)
Purchases, sales, issuances and settlements, net	6,769	-
Transfers in and/or out of Level 2	-	-
Ending balance June 30, 2011	$ 101,872	$ 236

Fair Value on a Nonrecurring Basis

Certain assets and liabilities 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). The following is a description of the valuation methodologies used for instruments measured at fair value on a nonrecurring basis:

Other Real Estate Owned ("OREO")
The fair value was determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

Impaired Collateral-Dependent Loans
The fair value of impaired collateral-dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral. The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At June 30, 2011, the valuation allowance for impaired loans was $3.9 million, an increase of $1.4 million from $2.5 million at December 31, 2010.

The following table presents the assets and liabilities carried on the balance sheet by caption and by level within the hierarchy (as described above) as of June 30, 2011:

	As of June 30, 2011				
(In thousands)	Level 1	Level 2	Level 3	Total	Total fair value loss during six months ended June 30, 2011
Financial Assets:					
Other real estate owned ("OREO")	$ -	$ -	$ 1,385	$ 1,385	$ (754)
Impaired collateral-dependent loans	-	-	21,020	21,020	(1,441)

Fair Value of Financial Instruments

FASB ASC Topic 825, “Financial Instruments,” requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of June 30, 2011 and December 31, 2010 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents
For these short-term instruments, the carrying value is a reasonable estimate of fair value.

Loans
The fair value of loans is estimated by discounting the future cash flows using current market rates that reflect the interest rate risk inherent in the loan, except for previously discussed impaired loans.

SBA loans held for sale
The fair value of SBA loans held for sale is estimated by using a market approach that includes significant other observable inputs.

Federal Home Loan Bank Stock
Federal Home Loan Bank stock is carried at cost. Carrying value approximates fair value based on the redemption provisions of the issues.

Deposit Liabilities
The fair value of demand deposits and savings accounts is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using current market rates.

Borrowed Funds & Subordinated Debentures
The fair value of borrowings is estimated by discounting the projected future cash flows using current market rates.

Accrued Interest
The carrying amounts of accrued interest approximate fair value.

Standby Letters of Credit
At June 30, 2011, the Bank had standby letters of credit outstanding of $2.0 million, as compared to $1.5 million at December 31, 2010. The fair value of these commitments is nominal.

The table below presents the estimated fair values of the Company’s financial instruments as of June 30, 2011 and December 31, 2010:

	June 30, 2011		December 31, 2010	
(In thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				

Cash and cash equivalents	$46,282	$ 46,282	$ 43,926	$ 43,926
Securities available for sale	101,872	101,872	107,131	107,131
Securities held to maturity	13,316	13,855	21,111	21,351
SBA loans held for sale	13,753	14,584	10,397	11,048
Loans, net of allowance for loan losses	585,334	585,245	591,175	588,519
Federal Home Loan Bank stock	4,088	4,088	4,206	4,206
SBA servicing assets	437	437	512	512
Accrued interest receivable	3,692	3,692	3,791	3,791
Financial liabilities:				
Deposits	641,167	624,128	654,788	634,713
Borrowed funds and subordinated debentures	90,465	102,915	90,465	103,704
Accrued interest payable	570	570	556	556
Interest rate swap agreements	236	236	499	499

Note 7.Securities

This table provides the major components of securities available for sale ("AFS") and held to maturity ("HTM") at amortized cost and estimated fair value at June 30, 2011 and December 31, 2010:

	June 30, 2011				December 31, 2010			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for sale:								
US Government sponsored entities	$ 8,379	$ 104	$ (4)	$ 8,479	$ 6,415	$ 47	$ -	$ 6,462
State and political subdivisions	11,240	341	(14)	11,567	11,246	23	(306)	10,963
Residential mortgage-backed securities	74,141	2,076	(205)	76,012	84,359	2,022	(640)	85,741
Commercial mortgage-backed securities	1,472	12	(5)	1,479	1,827	3	(4)	1,826
Trust preferred securities	978	-	(229)	749	977	-	(412)	565
Other securities	3,610	6	(30)	3,586	1,610	-	(36)	1,574
Total securities available for sale	$ 99,820	$ 2,539	$ (487)	$ 101,872	$ 106,434	$ 2,095	$ (1,398)	$ 107,131
Held to maturity:								
State and political subdivisions	$ 2,297	$ 93	$ -	$ 2,390	$ 2,297	$ -	$ (66)	$ 2,231
Residential mortgage-backed securities	8,261	367	(135)	8,493	14,722	444	(318)	14,848
Commercial mortgage-backed securities	2,708	264	-	2,972	4,042	217	-	4,259
Trust preferred securities	50	-	(50)	-	50	-	(37)	13
Total securities held to maturity	$ 13,316	$						