Solera National Bancorp, Inc.
Form 10-Q
November 13, 2012

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

# FORM 10-Q

(Mark one)
þQUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

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

Commission File Number 000-53181

SOLERA NATIONAL BANCORP, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 02-0774841 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

319 S. Sheridan Blvd.
Lakewood, CO 80226
303-209-8600
(Address and telephone number of principal executive offices and principal place of business)

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 þ 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ 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.

| | | | |
|---|---|---|---|
| Large accelerated filer | o | Accelerated filer | o |
| Non-accelerated filer | o | Smaller reporting company | þ |

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:  As of November 8, 2012, 2,553,671 shares of the registrant's common stock, $0.01 par value, were issued and outstanding.

FORM 10-Q

SOLERA NATIONAL BANCORP, INC.

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INTRODUCTORY NOTE. CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION AND RISK FACTORS

This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 about Solera National Bancorp, Inc. (the "Company") and our subsidiary, Solera National Bank (the "Bank," collectively with the Company, sometimes referred to as "we," "us" and "our") that are subject to risks and uncertainties. Forward-looking statements include information concerning future financial performance, business strategy, projected plans and objectives. Statements preceded by, followed by or that otherwise include the words "anticipates," "believes," "estimates," "expects," "intends," "plans," "may increase," "may fluctuate" and similar expres future or conditional verbs such as "will," "should," "would," and "could" are generally forward-looking in nature and not historical facts. Actual results may differ materially from those projected, implied, anticipated or expected in the forward-looking statements. Readers of this quarterly report should not rely solely on the forward-looking statements and should consider all uncertainties and risks throughout this report. The statements are representative only as of the date they are made, and Solera National Bancorp, Inc. undertakes no obligation to update any forward-looking statement.

These forward-looking statements, implicitly and explicitly, include the assumptions underlying the statements and other information with respect to the Company's beliefs, plans, objectives, goals, expectations, anticipations, estimates, financial condition, results of operations, future performance and business, including management's expectations and estimates with respect to revenues, expenses, return on equity, return on assets, efficiency ratio, asset quality and other financial data and capital and performance ratios.

Although the Company believes that the expectations reflected in the forward-looking statements are reasonable, these statements involve risks and uncertainties that are subject to change based on various important factors, some of which are beyond the control of the Company. The following factors, among others, could cause the Company's results or financial performance to differ materially from its goals, plans, objectives, intentions, expectations and other forward-looking statements:

management of Solera National Bank may be unable to limit credit risk associated with our loan portfolio, which would affect the Company's profitability;

general economic conditions in the U.S. and within our market area may be less favorable than expected, causing an adverse impact on our financial performance;

following a period of losses during the initial years of operations, the Company may not be able to demonstrate a sustained level of profitability;

the Company is subject to regulatory oversight, which could restrain our growth and profitability;

interest rate volatility could adversely impact our business;

the Company may not be able to raise additional capital on terms favorable to us;

the Company continues to hold other real estate owned which may be vulnerable to declines in real estate values;

the recently proposed Basel III capital standards may negatively impact our capital ratios, profitability and ability to lend;

the liquidity of our common stock is affected by its limited trading market; and the Company faces competition from a variety of competitors.

For a discussion of these and other risks and uncertainties that could cause actual results to differ from those contained in the forward-looking statements, see “Risk Factors” in Item 1A of the Company’s 2011 Annual Report filed on Form 10-K with the SEC, which is available on the SEC’s website at www.sec.gov and the Company’s website at www.solerabank.com. All forward-looking statements are qualified in their entirety by this cautionary statement, and the Company undertakes no obligation to revise or update this Quarterly Report on Form 10-Q to reflect events or circumstances after the date hereof. New factors emerge from time to time, and we cannot predict which factors, if any, will arise. In addition, the Company cannot assess the impact of each factor on the Company’s business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)
Solera National Bancorp, Inc.

Balance Sheets as of September 30, 2012 and December 31, 2011
(unaudited)

| ($ in thousands, except share data) | September 30, 2012 | December 31, 2011 |
|---|---|---|
| ASSETS | | |
| Cash and cash equivalents | $ 1,944 | $ 1,800 |
| Interest-bearing deposits with banks | 357 | 1,357 |
| Investment securities, available-for-sale | 84,921 | 83,195 |
| Gross loans | 61,664 | 55,645 |
| Net deferred expenses/(fees) | 215 | (77) |
| Allowance for loan and lease losses | (1,033) | (1,067) |
| Net loans | 60,846 | 54,501 |
| Federal Home Loan Bank (FHLB) and Federal Reserve Bank stocks | 1,175 | 1,134 |
| Bank-owned life insurance | 2,047 | - |
| Other real estate owned | 1,776 | 1,776 |
| Premises and equipment, net | 530 | 599 |
| Accrued interest receivable | 707 | 584 |
| Other assets | 419 | 420 |
| Total assets | $ 154,722 | $ 145,366 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Deposits | | |
| Noninterest-bearing demand | $ 2,958 | $ 3,550 |
| Interest-bearing demand | 8,299 | 9,355 |
| Savings and money market | 56,519 | 58,854 |
| Time deposits | 57,694 | 47,225 |
| Total deposits | 125,470 | 118,984 |
| Securities sold under agreements to repurchase and federal funds purchased | 254 | 253 |
| Accrued interest payable | 74 | 56 |
| Accounts payable and other liabilities | 456 | 534 |
| FHLB advances | 8,500 | 6,500 |
| Total liabilities | $ 134,754 | $ 126,327 |
| COMMITMENTS AND CONTINGENCIES (see Notes 10 and 12) | | |
| STOCKHOLDERS' EQUITY | | |
| | $ 26 | $ 26 |

| | | | | |
|---|---|---|---|---|
| Common stock, $0.01 par value; 5,000,000 shares authorized; 2,553,671 shares issued and outstanding | | | | |
| Additional paid-in capital | | 26,184 | | 26,146 |
| Accumulated deficit | | (7,472 ) | | (7,640 ) |
| Accumulated other comprehensive income | | 1,230 | | 507 |
| Total stockholders' equity | $ | 19,968 | $ | 19,039 |
| Total liabilities and stockholders' equity | $ | 154,722 | $ | 145,366 |

See Notes to Consolidated Financial Statements.

Solera National Bancorp, Inc.

Statements of Income and Comprehensive Income (Loss) for the
Three and Nine Months Ended September 30, 2012 and 2011
(unaudited)

| ($ in thousands, except share data) | For the Three Months Ended September 30, 2012 | For the Three Months Ended September 30, 2011 | For the Nine Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2011 |
|---|---|---|---|---|
| INTEREST INCOME: | | | | |
| Interest and fees on loans | $862 | $841 | $2,437 | $2,512 |
| Interest on investment securities | 505 | 578 | 1,548 | 1,897 |
| Dividends on FHLB and FRB stocks | 11 | 8 | 29 | 25 |
| Other interest income | 3 | 2 | 8 | 5 |
| Total interest income | 1,381 | 1,429 | 4,022 | 4,439 |
| INTEREST EXPENSE: | | | | |
| Deposits | 285 | 343 | 864 | 1,066 |
| FHLB advances | 34 | 51 | 98 | 157 |
| Other borrowings | 1 | 2 | 4 | 9 |
| Total interest expense | 320 | 396 | 966 | 1,232 |
| NET INTEREST INCOME BEFORE PROVISION | 1,061 | 1,033 | 3,056 | 3,207 |
| Provision for loan and lease losses | - | 10 | - | 130 |
| NET INTEREST INCOME AFTER PROVISION | 1,061 | 1,023 | 3,056 | 3,077 |
| NONINTEREST INCOME: | | | | |
| Service charges and fees | 20 | 16 | 54 | 52 |
| Other income | 20 | 3 | 49 | 5 |
| Gain on loans sold | - | - | 25 | - |
| (Loss) on sale of other real estate owned | - | (25) | - | (25) |
| Gain on sale of available-for-sale securities | 289 | 333 | 569 | 556 |
| Total noninterest income | 329 | 327 | 697 | 588 |
| NONINTEREST EXPENSE: | | | | |
| Salaries and employee benefits | 635 | 613 | 1,789 | 1,930 |
| Occupancy | 120 | 135 | 367 | 395 |
| Professional fees | 123 | 129 | 345 | 355 |
| Other general and administrative | 438 | 314 | 1,084 | 909 |
| Total noninterest expense | 1,316 | 1,191 | 3,585 | 3,589 |
| INCOME BEFORE INCOME TAXES | 74 | 159 | 168 | 76 |
| Provision for income taxes | - | - | - | - |
| NET INCOME | $74 | $159 | $168 | $76 |
| | | | | |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX: | | | | |
| Change in net unrealized gains on securities | 533 | (461) | 1,292 | 635 |
| Less: Reclassification adjustment for net gains included in net income | (289) | (333) | (569) | (556) |
| OTHER COMPREHENSIVE INCOME (LOSS) | $244 | $(794) | $723 | $79 |
| | | | | |
| COMPREHENSIVE INCOME (LOSS) | $318 | $(635) | $891 | $155 |
| | | | | |
| | $74 | $159 | $168 | $76 |

| | | | | |
|---|---|---|---|---|
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS | | | | |
| | | | | |
| INCOME PER COMMON SHARE | | | | |
| Basic | $0.03 | $0.06 | $0.07 | $0.03 |
| Weighted-average common shares outstanding - basic | 2,553,671 | 2,553,671 | 2,553,671 | 2,553,671 |
| Diluted | $0.03 | $0.06 | $0.07 | $0.03 |
| Weighted-average common shares outstanding - diluted | 2,565,105 | 2,553,671 | 2,559,020 | 2,553,671 |

See Notes to Consolidated Financial Statements.

Solera National Bancorp, Inc.

Statements of Changes in Stockholders' Equity for the
Nine Months Ended September 30, 2012 and 2011
(unaudited)

| ($ in thousands, except share data) | Shares Outstanding | Common Stock | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Income | Total |
|---|---|---|---|---|---|---|
| Balance at December 31, 2010 | 2,553,671 | $26 | $ 25,980 | $ (7,882 ) | $ 201 | $18,325 |
| Stock-based compensation | - | - | 158 | - | - | 158 |
| Comprehensive income: | | | | | | |
| Net income | - | - | - | 76 | - | 76 |
| Other comprehensive income | - | - | - | - | 79 | 79 |
| Total comprehensive income | | | | | | 155 |
| Balance at September 30, 2011 | 2,553,671 | $26 | $ 26,138 | $ (7,806 ) | $ 280 | $18,638 |
| | | | | | | |
| Balance at December 31, 2011 | 2,553,671 | $26 | $ 26,146 | $ (7,640 ) | $ 507 | $19,039 |
| Stock-based compensation | - | - | 38 | - | - | 38 |
| Comprehensive income: | | | | | | |
| Net income | - | - | - | 168 | - | 168 |
| Other comprehensive income | - | - | - | - | 723 | 723 |
| Total comprehensive income | | | | | | |
| Balance at September 30, 2012 | 2,553,671 | $26 | $ 26,184 | $ (7,472 ) | $ 1,230 | $19,968 |

See Notes to Consolidated Financial Statements.

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Solera National Bancorp, Inc.

Statements of Cash Flows for the
Nine Months Ended September 30, 2012 and 2011
(unaudited)

| ($ in thousands) | For the Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | $168 | $76 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 88 | 111 |
| Provision for loan and lease losses | - | 130 |
| Net accretion of deferred loan fees/expenses | (3) | (36) |
| Net amortization of premiums on investment securities | 1,122 | 529 |
| Gain on sale of SBA loans | 25 | - |
| Loss on sale of other real estate owned | - | 25 |
| Gain on sale of available-for-sale securities | (569) | (556) |
| Federal Home Loan Bank stock dividend | (6) | (2 |
| Recognition of stock-based compensation on stock options | 38 | 158 |
| Increase in bank-owned life insurance cash surrender value | (47) | - |
| Changes in operating assets and liabilities: | | |
| Accrued interest receivable | (123) | 193 |
| Other assets | 3 | 177 |
| Accrued interest payable | 18 | (25) |
| Accounts payable and other liabilities | (50) | 92 |
| Deferred loan fees/expenses, net | (289) | 19 |
| Net cash provided by operating activities | $375 | $891 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchase of investment securities, available-for-sale | $(44,095) | $(47,845) |
| Proceeds from sales of investment securities, available-for-sale | 31,828 | 34,963 |
| Proceeds from maturities/pay downs of investment securities, available-for-sale | 10,711 | 7,424 |
| Loan originations funded, net | (6,078) | 2,048 |
| (Purchase) / redemption of Federal Reserve Bank stock | (35) | 22 |
| Purchase of bank-owned life insurance | (2,000) | - |
| Purchase of premises and equipment | (21) | (3) |
| Proceeds from sale of other real estate owned | - | 1,813 |
| Maturity / (purchase) of interest-bearing deposits with banks, net | 1,000 | (91) |
| Net cash used in investing activities | $(8,690) | $(1,669) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net increase in deposits | $6,486 | $1,615 |
| Net increase in securities sold under agreements to repurchase and federal funds purchased | 1 | 44 |
| Increase / (decrease) in FHLB advances | 2,000 | (1,500) |
| Principal payments on capital lease | (28) | (34) |

| | | |
|---|---|---|
| Net cash provided by financing activities | $8,459 | $125 |
| | | |
| Net increase / (decrease) in cash and cash equivalents | $144 | $(653) |
| CASH AND CASH EQUIVALENTS | | |
| Beginning of period | 1,800 | 936 |
| End of period | $1,944 | $283 |

(continued)

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Solera National Bancorp, Inc.

Statements of Cash Flows for the
Nine Months Ended September 30, 2012 and 2011, (continued)
(unaudited)

| ($ in thousands) | For the Nine Months Ended September 30, 2012 | | 2011 | |
|---|---|---|---|---|
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | | | |
| Cash paid during the period for: | | | | |
| Interest | $ | 948 | $ | 1,257 |
| Income taxes paid | $ | - | $ | - |
| Non-cash investing transactions: | | | | |
| Unrealized gain on investment securities, available-for-sale | $ | 723 | | 79 |
| Loans transferred to OREO | $ | - | $ | 903 |

See Notes to Consolidated Financial Statements.

SOLERA NATIONAL BANCORP, INC.

UNAUDITED CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 — SUMMARY OF ORGANIZATION

Solera National Bancorp, Inc. (the "Company"), is a Delaware corporation that was incorporated in 2006 to organize and serve as the holding company for Solera National Bank (the "Bank"), a national bank that opened for business on September 10, 2007. Solera National Bank is a full-service community, commercial bank headquartered in Lakewood, Colorado primarily serving the six-county Denver metropolitan area.

NOTE 2 — BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) which, in the opinion of management, are necessary to present fairly the financial position of the Company as of September 30, 2012, and the results of its operations for the three and nine months ended September 30, 2012 and 2011. Cash flows are presented for the nine months ended September 30, 2012 and 2011. Certain reclassifications have been made to the consolidated financial statements and related notes of prior periods to conform to the current presentation. These reclassifications had no impact on stockholders' equity or net income (loss) for the periods. Additionally, certain information and footnote disclosures normally included in financial statements have been condensed or omitted pursuant to rules and regulations of the U.S. Securities and Exchange Commission. The Company believes that the disclosures in the unaudited condensed consolidated financial statements are adequate to make the information presented not misleading. However, these unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Critical Accounting Policies

The following is a description of the Company's significant accounting policies used in the preparation of the accompanying consolidated financial statements.

Provision and allowance for loan and lease losses: Implicit in the Company's lending activities is the fact that loan and lease losses will be experienced and that the risk of loss will vary with the type of loans being made and the creditworthiness of the borrowers over the terms of the loans. The allowance for loan and lease losses represents the Company's recognition of the risks of extending credit and its evaluation of the loan portfolio. The evaluation of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan and lease losses is maintained at a level considered adequate to provide for probable loan and lease losses based on management's assessment of various factors affecting the loan portfolio, including a review of problem loans, business conditions, historical loss experience, evaluation of the quality of the underlying collateral, and holding and disposal costs. In addition, because the Bank has limited history on which to base future loan and lease losses, a comparison of peer group allowance ratios to gross loans is made with the intention of maintaining similar levels until the Bank has sufficient historical data to see trends in our own loss history. The allowance for loan and lease losses is increased by provisions charged to expense and reduced by loans and leases charged-off, net of recoveries. Loan and lease losses are charged against the allowance for loan and lease losses when management believes the balance is uncollectible.

The Company has established a formal process for determining an adequate allowance for loan and lease losses. The allowance for loan and lease losses calculation has two components. The first component represents the allowance for loan and lease losses for impaired loans; that is, loans where the Company believes collection of the contractual principal and interest payments is not probable. To determine this component of the calculation, impaired loans and leases are individually evaluated by either discounting the expected future cash flows or determining the fair value of the collateral, if repayment is expected solely from collateral. The fair value of the collateral is determined using internal analyses as well as third-party information, such as appraisals. That value, less estimated costs to sell, is compared to the recorded investment in the loan and any shortfall is charged-off. Unsecured loans and loans that are not collateral-dependent are evaluated by calculating the discounted cash flow of the payments expected over the life of the loan using the loan's effective interest rate and giving consideration to currently existing factors that would impact the amount or timing of the cash flows. The shortfall between the recorded investment in the loan and the discounted cash flows, or the fair value of the collateral less estimated costs to sell, represents the first component of the allowance for loan and lease losses.

The second component of the allowance for loan and lease losses represents contingent losses – the estimated probable losses inherent within the portfolio due to uncertainties. To determine this component, management calculates a weighted-average loss rate based on actual loss rates over the last two to three years for all banks in Colorado and for similarly-sized commercial banks with two or fewer locations in a metropolitan area. Management then adjusts the loss rate for environmental factors which include, but are not limited to, 1) historical and current trends in downgraded loans; 2) the level of the allowance in relation to total loans; 3) the levels and trends in non-performing and past due loans; and 4) management's assessment of economic conditions and certain qualitative factors as defined by bank regulatory guidance, including but not limited to, changes in the size, composition and concentrations of the loan portfolio, changes in the legal and regulatory environment, and changes in lending management. The qualitative factors also consider the risk elements within each segment of the loan portfolio. The primary risk comes from the difference between the expected and actual cash flows of the borrower and is influenced by the type of collateral securing the loans. For real estate secured loans, conditions in the real estate markets as well as the general economy influence real estate values and may impact the Company's ability to recover its investment due to declines in the fair value of the underlying collateral. The risks in non-real estate secured loans include general economic conditions as well as interest rate changes. Classified and criticized loans, which are closely monitored by management, are taken out of their original category for calculating their contingent loss rate and are assigned a loss rate ranging between 2.50% and 17.50% of the loan's principal balance. The aggregate of above described segments represents the contingent losses in the portfolio.

The recorded allowance for loan and lease losses is the aggregate of the impaired loan and lease component and the contingent loss component. We aggregate our loans into portfolio segments including: Commercial Real Estate Secured; Residential Real Estate Secured; Commercial and Industrial; and Consumer. These segments are based upon the loan's categorization in the Consolidated Report of Condition and Income, as set forth by banking regulators, (the "Call Report"). Our methodology for estimating the allowance has not changed during the current or prior reporting period and is consistent across all portfolio segments and classes of loans.

At September 30, 2012, the Company had an allowance for loan and lease losses of $1.0 million. We believe that this is adequate to cover probable losses based on currently available evidence. Future additions to the allowance for loan and lease losses may be required based on management's continuing evaluation of the inherent risks in the portfolio. Additional provisions for loan and lease losses may be needed if the economy declines, asset quality deteriorates, or the loss experience changes.

Loans receivable: Loans receivable that the Company has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances net of any deferred fees or costs, and reduced by any charge-offs and the allowance for loan and lease losses.

Credit and loan decisions are made by management and the Board of Directors' Credit Committee in conformity with established loan policies. The Company's practice is to charge-off any loan or portion of a loan when the loan is determined to be uncollectible due to the borrower's failure to meet repayment terms, the borrower's deteriorated financial condition, the depreciation of the underlying collateral, the loan's classification as a loss, or for other reasons.

The Company considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Measurement of impairment is based on the expected future cash flows of an impaired loan, which are to be discounted at the loan's effective interest rate, or measured by reference to an observable market value, if one exists, or the fair value of the collateral for a collateral-dependent loan. The Company selects the measurement method on a loan-by-loan basis except that collateral-dependent loans for which foreclosure is probable are measured at the fair value of the collateral. The Company recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans (see Interest and fees on loans, below).

Interest and fees on loans: Interest income is recognized daily in accordance with the terms of the note based on the outstanding principal balance. Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. The accrual of interest on loans is discontinued when principal or interest is 90 days past due based on contractual terms of the loan or when, in the opinion of management, there is reasonable doubt as to collectability. When loans are placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on nonaccrual loans is subsequently recognized only to the extent that cash is received and the Bank's recorded investment in the loan (the customer's balance less any partial charge-offs) is deemed collectible. Interest accruals are resumed on such loans only when they are brought current and when, in the judgment of management, the loans are estimated to be fully collectible as to all interest and the Bank's recorded investment.

Generally, for all classes of loans, loans are considered past due when contractual payments are delinquent by 30 days or more.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan using the effective interest method and without anticipating prepayments.

Share-based compensation:  The Company grants stock options as incentive compensation to employees and directors.  The cost of employee/director services received in exchange for an award of equity instruments is based on the grant-date fair value of the award, which is determined using a Black-Scholes-Merton model.  This cost, net of estimated forfeitures, is expensed to salaries and employee benefits over the period in which the recipient is required to provide services in exchange for the award, generally the vesting period.

Estimation of fair value:  The estimation of fair value is significant to a number of the Company's assets, including available-for-sale investment securities.  These are all recorded at either fair value or at the lower of cost or fair value.  Furthermore, accounting principles generally accepted in the United States require disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements.  Fair values are volatile and may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of the yield curve.  Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the most advantageous market for the asset or liability in an orderly transaction between market participants.  The fair value hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.  Current accounting standards describe three levels of inputs that may be used to measure fair values:

Level 1 – inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 – inputs are other than quoted prices included in Level 1 that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – valuation is generated from model-based techniques that use at least one significant assumption not observable in the market.  These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability.  Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Impairment of investment securities:  Investment securities are evaluated for impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value below amortized cost is other-than-temporary.  Securities are evaluated for impairment utilizing criteria such as the magnitude and duration of the decline, current market conditions, payment history, the credit worthiness of the obligor, the intent of the Company to retain the security or whether it is more likely than not that the Company will be required to sell the security before recovery of the value, as well as other qualitative factors.  If a decline in value below amortized cost is determined to be other-than-temporary, which does not necessarily indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not favorable, the security is reviewed in more detail in order to determine the portion of the impairment that relates to credit (resulting in a charge to earnings) versus the portion of the impairment that is noncredit related (resulting in a charge to accumulated other comprehensive income).  If it is more likely than not that sale of the security will be required prior to recovery of its amortized cost, the entire impairment is recognized in earnings equal to the difference between the amortized cost basis and the fair value.  A credit loss is determined by comparing the amortized cost basis to the present value of cash flows expected to be collected, computed using the original yield as the discount rate.

Income (loss) per common share:  Basic earnings per common share, (EPS), is based on the weighted-average number of common shares outstanding during the period.  Diluted earnings per share is similar to basic EPS except that the weighted-average number of common shares outstanding is increased by the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued at the beginning of the period.  For the three and nine months ended September 30, 2012, the weighted-average dilutive stock options outstanding totaled 11,434 and 5,349, respectively.  Given the small amount of dilutive potential stock options, diluted EPS did not differ from basic EPS for the three or nine months ended September 30, 2012.  Similarly, since the vast majority of the Company's stock options were out of the money during 2011, there were no dilutive potential common shares at September 30, 2011 and, therefore, no difference between diluted EPS and basic EPS.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board, ("FASB"), issued an accounting standards update intended to improve the comparability of fair value accounting and reporting requirements between United States Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). Additional disclosures required by the update are incorporated in Note 11 and include: (i) disclosure of quantitative information regarding the unobservable inputs used in any Level 3 measurement including an explanation of the valuation techniques used and the sensitivity to changes in the values assigned to unobservable inputs; (ii) categorization by level for the fair value of financial instruments; and (iii) instances where the fair values disclosed for non-financial assets were based on a highest and best use assumption when in fact the assets are not being utilized in that capacity. The amendments in the update are effective for the Company's interim and annual reports beginning with the first quarter 2012. The provisions of this update did not have a material impact on the Company's financial position, results of operations or cash flows but did cause changes to the Company's fair value disclosure (see Note 11).

In June 2011, the FASB issued an accounting standards update to increase the prominence of items included in Other Comprehensive Income and facilitate the convergence of U.S. GAAP with IFRS. The update prohibits continued exclusive presentation of Other Comprehensive Income in the statement of stockholders' equity. The update requires that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but continuous statements. The amendments in the update are effective for the Company's interim and annual reports beginning with the first quarter 2012. The provisions of this update did not have a material impact on the Company's financial position, results of operations or cash flows but did cause changes to the presentation of the Company's Statements of Income.

During the first nine months of 2012, the FASB issued other accounting standards updates which may impact the banking community or other entities but do not, and are not expected to, have a material impact on our financial position, results of operations or cash flows.

NOTE 3 — INVESTMENTS

The amortized costs and estimated fair values of investment securities as of September 30, 2012 and December 31, 2011 are as follows:

| ($ in thousands) | September 30, 2012 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Securities available-for-sale: | | | | |
| Corporate | $14,963 | $543 | $(173) | $15,333 |
| State and municipal | 16,836 | 366 | (28) | 17,174 |
| Residential agency mortgage-backed securities ("MBS") | 51,892 | 622 | (100) | 52,414 |
| Total securities available-for-sale | $83,691 | $1,531 | $(301) | $84,921 |

| ($ in thousands) | December 31, 2011 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Securities available-for-sale: | | | | |
| Corporate | $15,117 | $161 | $(460) | $14,818 |
| State and municipal | 3,691 | 198 | (4) | 3,885 |

| | | | | |
|---|---|---|---|---|
| Residential agency MBS | 63,880 | 747 | (135) | 64,492 |
| Total securities available-for-sale | $82,688 | $1,106 | $(599) | $83,195 |

The amortized cost and estimated fair value of investment securities by contractual maturity at September 30, 2012 and December 31, 2011 are shown below. The timing of principal payments received differs from the contractual maturity because borrowers may be required to make contractual principal payments and often have the right to prepay obligations with or without prepayment penalties. As a result, the timing with which principal payments are received on mortgage-backed securities ("MBS") is not represented in the tables below. For instance, we received $10.7 million in proceeds from the maturity /prepayment of securities during the nine months ended September 30, 2012 (see our Consolidated Statements of Cash Flows on page 7) versus no dollars contractually maturing within one year as of December 31, 2011, as set forth in the table below.

| ($ in thousands) | September 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| Securities available-for-sale: | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Due within one year | $1,004 | $1,036 | $- | $- |
| Due after one year through five years | 6,309 | 6,514 | 8,540 | 8,583 |
| Due after five years through ten years | 20,763 | 21,223 | 13,799 | 13,720 |
| Due after ten years | 55,615 | 56,148 | 60,349 | 60,892 |
| Total securities available-for-sale | $83,691 | $84,921 | $82,688 | $83,195 |

The following tables show the estimated fair value and gross unrealized losses, aggregated by investment category and length of time the individual securities have been in a continuous loss position as of September 30, 2012 and December 31, 2011.

| ($ in thousands) | September 30, 2012 Less than 12 months | | | 12 months or more | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| Description of securities: | Estimated Fair Value | Unrealized Losses | # of Securities | Estimated Fair Value | Unrealized Losses | # of Securities | Estimated Fair Value | Unrealized Losses | # of Securities |
| Corporate | $ - | $ - | - | $ 4,327 | $ (173 ) | 7 | $ 4,327 | $ (173 ) | 7 |
| State and municipal | 3,433 | (28 ) | 7 | - | - | - | 3,433 | (28 ) | 7 |
| Residential agency MBS | 13,006 | (90 ) | 13 | 1,290 | (10 ) | 2 | 14,296 | (100 ) | 15 |
| Total temporarily-impaired | $ 16,439 | $ (118 ) | 20 | $ 5,617 | $ (183 ) | 9 | $ 22,056 | $ (301 ) | 29 |

| ($ in thousands) | December 31, 2011 Less than 12 months | | | 12 months or more | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| Description of securities: | Estimated Fair Value | Unrealized Losses | # of Securities | Estimated Fair Value | Unrealized Losses | # of Securities | Estimated Fair Value | Unrealized Losses | # of Securities |
| Corporate | $ 4,033 | $ (180 ) | 8 | $ 4,220 | $ (280 ) | 7 | $ 8,253 | $ (460 ) | 15 |
| State and municipal | 502 | (4 ) | 1 | - | - | - | 502 | (4 ) | 1 |
| Residential agency MBS | 18,266 | (135 ) | 20 | - | - | - | 18,266 | (135 ) | 20 |
| Total temporarily-impaired | $ 22,801 | $ (319 ) | 29 | $ 4,220 | $ (280 ) | 7 | $ 27,021 | $ (599 ) | 36 |

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Management evaluates investment securities for other-than-temporary impairment taking into consideration the extent and length of time the fair value has been less than cost, the financial condition of the issuer, whether the Company has the intent to retain the security and whether it is more-likely-than-not that the Company will be required to sell the security before recovery of the value, as well as other qualitative factors. As of September 30, 2012, no declines were deemed to be other than temporary. The seven corporate securities that were in a continuous loss position for 12 months or longer at September 30, 2012 fluctuated in value primarily as a result of changes in market interest rates and the widening of spreads due to an increase in the perceived risk of these bonds largely due to the problems with European banks rather than due to a material deterioration in credit quality. Further, the amount of unrealized loss on these corporate bonds has declined in 2012.

Anticipated increases in prepayment speeds on residential agency MBS, especially those with relatively high coupons, is the primary driver for the two mortgage-backed securities in a continuous loss position for 12 months or longer at September 30, 2012. The Company has determined there is no credit impairment on these bonds since they carry the implicit guarantee of the U.S. government. Further, the Company has the intent to hold the securities in an unrealized loss position as of September 30, 2012 and does not anticipate that these securities will be required to be sold before recovery of value, which may be upon maturity. Accordingly, the securities detailed in the table above, are not other than temporarily impaired. Similarly, management's evaluation of the securities in an unrealized loss position at December 31, 2011, determined these securities were not other than temporarily impaired.

The Company recorded a net unrealized gain in the investment portfolio of $1.2 million at September 30, 2012, a 143% increase over the $507,000 net unrealized gain at December 31, 2011.

Sales of available-for-sale securities were as follows:

| ($ in thousands) | Three Months Ended September 30, 2012 | Three Months Ended September 30, 2011 | Nine Months Ended September 30, 2012 | Nine Months Ended September 30, 2011 |
|---|---|---|---|---|
| Proceeds | $ 12,384 | $ 9,905 | $ 31,828 | $ 34,963 |
| Gross gains | $ 300 | $ 333 | $ 580 | $ 685 |
| Gross losses | $ (11) | $ - | $ (11) | $ (129) |

The $11,000 of losses during the third quarter 2012 relates to the sale of one bond that was not in an unrealized loss position as of June 30, 2012. The bond was a high-coupon, seasoned residential agency MBS which was experiencing accelerated prepayment speeds resulting in negative book yields. Realized gains and losses on sales are computed on a specific identification basis based on amortized cost on the date of sale.

Securities with carrying values of $25.4 million at September 30, 2012 and $20.4 million at December 31, 2011, were pledged as collateral to secure public deposits, borrowings from the FHLB, repurchase agreements and for other purposes as required or permitted by law.

NOTE 4 — LOANS

The following table sets forth the composition of the loan portfolio according to the loan's purpose, which may differ from the categorization of the loan in subsequent tables which categorize the loan according to its underlying collateral:

| ($ in thousands) | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Commercial real estate ("CRE") | $ 36,556 | $ 37,862 |
| Commercial and industrial | 10,421 | 5,971 |
| Residential real estate | 12,836 | 10,460 |
| Construction and land development | 1,323 | 1,307 |
| Consumer | 528 | 45 |
| GROSS LOANS | 61,664 | 55,645 |
| Net deferred loan expenses / (fees) | 215 | (77) |
| Allowance for loan and lease losses | (1,033) | (1,067) |
| LOANS, NET | $ 60,846 | $ 54,501 |

During the first nine months of 2012, the Bank purchased fourteen loans with principal balances totaling approximately $4.5 million. No loans were purchased during 2011. During the second quarter 2012, the Bank sold the guaranteed portion of an SBA 7(a) note and recognized a $25,000 gain on sale. No loans were sold during 2011.

In the ordinary course of business, and only if consistent with permissible exceptions to Section 402 of the Sarbanes-Oxley Act of 2002, the Bank may make loans to directors, executive officers, principal stockholders (holders of more than five percent of the outstanding common shares) and the businesses with which they are associated. In the Company's opinion, all loans and loan commitments to such parties are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons. There were approximately $170,000 and $481,000 in loans receivable from related parties at September 30, 2012 and December 31, 2011, respectively.

The Company's loan portfolio generally consists of loans to borrowers within Colorado. Although the Company seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, the Company's loan portfolio consists primarily of loans secured by real estate located in Colorado, making the value of the portfolio more susceptible to declines in real estate values and other changes in economic conditions in Colorado. No single borrower can be approved for a loan over the Bank's current legal lending limit of approximately $2.6 million. This regulatory requirement helps to ensure the Bank's exposure to one individual customer is limited.

NOTE 5 — ALLOWANCE FOR LOAN AND LEASE LOSSES

Activity in the allowance for loan and lease losses for the three and nine months ended September 30, 2012 and 2011 is summarized as follows:

| ($ in thousands) | Three Months Ended September 30, 2012 | 2011 | Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|---|---|
| Balance, beginning of period | $1,009 | $1,284 | $1,067 | $1,175 |
| Charge-offs | - | (225) | (88) | (236) |
| Recoveries | 24 | - | 54 | - |
| Provision for loan and lease losses | - | 10 | - | 130 |
| Balance, end of period | $1,033 | $1,069 | $1,033 | $1,069 |

The following allowance for loan and lease loss disclosures are broken out by portfolio segment. Portfolio segment is defined, under current U.S. GAAP, as the level of aggregation used by the Company to calculate its allowance for loan and lease losses. Our portfolio segments are based on how loans are categorized on the Call Report, which is primarily based on the collateral securing the loan. We have four main portfolio segments as follows:

Commercial Real Estate (CRE) Secured – loans secured by nonfarm, nonresidential properties
Residential Real Estate Secured – loans secured by 1-4 family residential properties or land
Commercial and Industrial – loans to businesses not secured by real estate, and
Consumer – loans to individuals not secured by real estate.

The portfolio segment categorization of loans differs from the categorization shown in Note 4 – Loans. Portfolio segment categorization is based on the Call Report and the loan's underlying collateral while the loan categorization in Note 4 – Loans is based on the loan's purpose as determined during the underwriting process.

The tables below provide a rollforward, by portfolio segment, of the allowance for loan and lease losses for the three and nine months ended September 30, 2012 and 2011, respectively.

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment
Three Months Ended September 30, 2012

| ($ in thousands) | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
|---|---|---|---|---|---|
| Balance at June 30, 2012 | $665 | $247 | $96 | $1 | $1,009 |
| Charge-offs | - | - | - | - | - |
| Recoveries | - | 14 | 10 | - | 24 |
| Provision for loan and lease losses | 32 | (27) | (5) | - | - |
| Balance at September 30, 2012 | $697 | $234 | $101 | $1 | $1,033 |

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment
Nine Months Ended September 30, 2012

| ($ in thousands) | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
|---|---|---|---|---|---|
| Balance at December 31, 2011 | $726 | $244 | $97 | $- | $1,067 |
| Charge-offs | - | - | (85) | (3) | (88) |
| Recoveries | - | 44 | 10 | - | 54 |
| Provision for loan and lease losses | (29) | (54) | 79 | 4 | - |
| Balance at September 30, 2012 | $697 | $234 | $101 | $1 | $1,033 |

The components of the provision for loan and lease losses have changed during the nine months ended September 30, 2012 primarily due to the need to replenish the allowance for commercial and industrial loans following an $85,000 charge-off. In aggregate, no provision expense was required during the three and nine month periods due to improving asset quality in both commercial and residential real estate secured loans.

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment
Three Months Ended September 30, 2011

| ($ in thousands) | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
|---|---|---|---|---|---|
| Balance at June 30, 2011 | $723 | $432 | $128 | $1 | $1,284 |
| Charge-offs | - | (109) | (116) | - | (225) |
| Recoveries | - | - | - | - | - |
| Provision for loan and lease losses | 68 | (145) | 87 | - | 10 |
| Balance at September 30, 2011 | $791 | $178 | $99 | $1 | $1,069 |

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment
Nine Months Ended September 30, 2011

| ($ in thousands) | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
|---|---|---|---|---|---|
| Balance at December 31, 2010 | $524 | $314 | $336 | $1 | $1,175 |
| Charge-offs | (11) | (109) | (116) | - | (236) |
| Recoveries | - | - | - | - | - |
| Provision for loan and lease losses | 278 | (27) | (121) | - | 130 |
| Balance at September 30, 2011 | $791 | $178 | $99 | $1 | $1,069 |

The following tables present the ending balance in loans and allowance for loan and lease losses, broken down by portfolio segment as of September 30, 2012 and December 31, 2011. The tables also identify the recorded investment in loans and the related allowance that correspond to individual versus collective impairment evaluation as derived from the Company's methodology of estimating the allowance for loan and lease losses (see additional discussion about our allowance methodology under Note 2: Critical Accounting Policies, Provision and allowance for loan and lease losses).

Ending Balances in Loans and Allowance for Loan and Lease Losses by Portfolio Segment
September 30, 2012

| ($ in thousands) | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
|---|---|---|---|---|---|
| Loans | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ 13 | $ - | $ 13 |
| Collectively evaluated for impairment | 32,869 | 18,480 | 10,248 | 54 | 61,651 |
| Total | $ 32,869 | $ 18,480 | $ 10,261 | $ 54 | $ 61,664 |
| | | | | | |
| Allowance for loan losses | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - |
| Collectively evaluated for impairment | 697 | 234 | 101 | 1 | 1,033 |
| Total | $ 697 | $ 234 | $ 101 | $ 1 | $ 1,033 |

Ending Balances in Loans and Allowance for Loan and Lease Losses by Portfolio Segment
December 31, 2011

| ($ in thousands) | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
|---|---|---|---|---|---|
| Loans | | | | | |
| Individually evaluated for impairment | $ 274 | $ - | $ 336 | $ - | $ 610 |
| Collectively evaluated for impairment | 35,159 | 14,586 | 5,245 | 45 | 55,035 |
| Total | $ 35,433 | $ 14,586 | $ 5,581 | $ 45 | $ 55,645 |
| | | | | | |
| Allowance for loan losses | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - |
| Collectively evaluated for impairment | 726 | 244 | 97 | - | 1,067 |
| Total | $ 726 | $ 244 | $ 97 | $ - | $ 1,067 |

The remaining tables in the allowance for loan and lease losses footnote provide detail about loans according to their class, rather than their segment, as reflected above. The class level provides more detail than the portfolio segment level. The following tables contain reconciliation information between the portfolio segment levels and class levels:

Reconciliation between Portfolio Segment and Class
September 30, 2012 (Principal Balance)

| ($ in thousands) | Portfolio Segment | | | | |
|---|---|---|---|---|---|
| Class | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
| CRE – owner occupied | $18,507 | $- | $- | $- | $18,507 |
| CRE – non-owner occupied | 13,734 | - | - | - | 13,734 |
| Commercial and industrial | - | - | 10,261 | - | 10,261 |
| Residential real estate | - | 17,785 | - | - | 17,785 |
| Construction and land development | 628 | 695 | - | - | 1,323 |
| Consumer | - | - | - | 54 | 54 |
| Total | $32,869 | $18,480 | $10,261 | $54 | $61,664 |

Reconciliation between Portfolio Segment and Class
December 31, 2011 (Principal Balance)

| ($ in thousands) | Portfolio Segment | | | | |
|---|---|---|---|---|---|
| Class | Commercial Real Estate Secured | Residential Real Estate Secured | Commercial and Industrial | Consumer | Total |
| CRE – owner occupied | $16,337 | $- | $- | $- | $16,337 |
| CRE – non-owner occupied | 18,367 | - | - | - | 18,367 |
| Commercial and industrial | - | - | 5,581 | - | 5,581 |
| Residential real estate | - | 14,008 | - | - | 14,008 |
| Construction and land development | 729 | 578 | - | - | 1,307 |
| Consumer | - | - | - | 45 | 45 |
| Total | $35,433 | $14,586 | $5,581 | $45 | $55,645 |

Impaired Loans

The following tables provide detail of impaired loans broken out according to class as of September 30, 2012 and December 31, 2011. The class level represents a slightly more detailed level than the portfolio segment level. There was one impaired loan, totaling $13,000, as of September 30, 2012 compared to three impaired loans totaling $610,000 as of December 31, 2011. The recorded investment represents the customer balance less any partial charge-offs and excludes any accrued interest receivable since the majority of the loans are on nonaccrual status and therefore do not have interest accruing. The unpaid principal balance represents the unpaid principal prior to any partial charge-off. There were no impaired loans with a related allowance as of September 30, 2012 or December 31, 2011.

| | Impaired Loans by Class as of September 30, 2012 | | | | |
|---|---|---|---|---|---|
| ($ in thousands) | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment YTD | Interest Income Recognized YTD |
| Impaired loans with no related allowance | | | | | |
| CRE – owner occupied | $- | $- | $- | $- | $ - |
| CRE – non-owner occupied | - | - | - | - | - |
| Commercial and industrial | 13 | 13 | - | 73 | 2 |
| Residential real estate | - | - | - | - | - |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total | $13 | $13 | $- | $73 | $ 2 |

| | Impaired Loans by Class as of December 31, 2011 | | | | |
|---|---|---|---|---|---|
| ($ in thousands) | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment YTD | Interest Income Recognized YTD |
| Impaired loans with no related allowance | | | | | |
| CRE – owner occupied | $- | $- | $- | $- | $ - |
| CRE – non-owner occupied | 274 | 494 | - | 345 | - |
| Commercial and industrial | 336 | 336 | - | 517 | 15 |
| Residential real estate | - | - | - | - | - |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total | $610 | $830 | $- | $862 | $ 15 |

As of both September 30, 2012 and December 31, 2011, the impaired loans without a valuation allowance did not have a related allowance because they have either been partially charged-off, bringing them to their net realizable value, or are well-secured.

Troubled debt restructurings (TDRs) are included in impaired loans above. No loans were modified as TDRs during the three or nine months ended September 30, 2012. A TDR is considered to be in payment default once it is 90 days past due under the modified terms or when the loan is determined to be uncollectible and is classified as loss and charged-off. One loan, totaling $85,000, that was restructured during the last 12 months subsequently defaulted and was charged-off during the second quarter 2012.

The following tables present loans, by class, that have been modified as TDRs during the three and nine months ended September 30, 2011, respectively:

TDRs during the Three Months Ended September 30, 2011

| ($ in thousands) | # of Loans | Pre-Modification Recorded Investment | Recorded Investment as of September 30, 2011 |
|---|---|---|---|
| Loan Class | | | |
| CRE – owner occupied | - | $ - | $ - |
| CRE – non-owner occupied | 1 | 369 | 318 |
| Commercial and industrial | 1 | 99 | 95 |
| Residential real estate | - | - | - |
| Construction and land development | - | - | - |
| Consumer | - | - | - |
| Total | 2 | $ 468 | $413 |

The commercial real estate restructuring involves an extension of terms and the commercial and industrial modification involves a rate concession and an extension of terms.

TDRs during the Nine Months Ended September 30, 2011

| ($ in thousands) | # of Loans | Pre-Modification Recorded Investment | Recorded Investment as of September 30, 2011 |
|---|---|---|---|
| Loan Class | | | |
| CRE – owner occupied | - | $ - | $ - |
| CRE – non-owner occupied | 1 | 369 | 318 |
| Commercial and industrial | 1 | 99 | 95 |
| Residential real estate | 1 | 161 | - |
| Construction and land development | - | - | - |
| Consumer | - | - | - |
| Total | 3 | $ 629 | $413 |

The CRE – non-owner occupied restructuring involves an extension of terms. The commercial and industrial modification involves a rate concession and an extension of terms. The residential real estate restructuring includes partial debt forgiveness and a rate concession.

At September 30, 2011, there were three loans with terms that were modified in a TDR; including the $413,000 shown in the table above. None of the TDRs as of September 30, 2011 had a specific valuation allowance because the loans were well collateralized or had been partially charged-off to their net realizable values. Year to date charge-offs on TDRs totaled $120,000 as of September 30, 2011. As of September 30, 2011, the Company had two loans that were restructured within the last 12 months that subsequently defaulted.

Age Analysis of Loans

The following tables summarize, by class, our past due and nonaccrual loans as of the dates indicated.

| | Age Analysis of Loans by Class as of September 30, 2012 | | | | |
|---|---|---|---|---|---|
| ($ in thousands) | 30-59 Days Past Due | 60-89 Days Past Due | Past Due 90 Days or More and Still Accruing | Nonaccrual | Total Past Due and Nonaccrual |
| CRE – owner occupied | $- | $- | $- | $- | $- |
| CRE – non-owner occupied | - | - | - | - | - |
| Commercial and industrial | - | - | - | 13 | 13 |
| Residential real estate | - | - | - | - | - |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total | $- | $- | $- | $13 | $13 |

| | Age Analysis of Loans by Class as of December 31, 2011 | | | | |
|---|---|---|---|---|---|
| ($ in thousands) | 30-59 Days Past Due | 60-89 Days Past Due | Past Due 90 Days or More and Still Accruing | Nonaccrual | Total Past Due and Nonaccrual |
| CRE – owner occupied | $ - | $ 1,040 | $ - | $ - | $ 1,040 |
| CRE – non-owner occupied | - | - | - | 274 | 274 |
| Commercial and industrial | - | - | - | 336 | 336 |
| Residential real estate | 139 | 170 | - | - | 309 |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total | $ 139 | $ 1,210 | $ - | $ 610 | $ 1,959 |

Credit Quality Information

The Company uses the following definitions for risk ratings, which are consistent with the definitions used in supervisory guidance and are the same for all classes of loans:

Special Mention: Loans in this category have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment at some future date.

Substandard: Loans in this category are inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any. These loans have well-defined weaknesses that jeopardize the liquidation of the debt and have the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans in this category have all the weaknesses inherent in those classified as substandard, above, with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

Loss: Loans in this category are deemed not collectible and are charged-off.

Loans not meeting any of the definitions above are considered to be pass rated loans.

As of September 30, 2012, and based on the most recent analysis performed during the month of September 2012, the recorded investment in each risk category of loans by class of loan is as follows:

| | Credit Quality of Loans by Class as of September 30, 2012 | | | | |
|---|---|---|---|---|---|
| ($ in thousands) | Pass | Special Mention | Substandard | Doubtful | Total |
| CRE – owner occupied | $15,572 | $1,012 | $1,923 | $- | $18,507 |
| CRE – non-owner occupied | 11,604 | 2,130 | - | - | 13,734 |
| Commercial and industrial | 9,994 | 170 | 97 | - | 10,261 |
| Residential real estate | 17,143 | - | 642 | - | 17,785 |
| Construction and land development | 527 | - | 796 | - | 1,323 |
| Consumer | 42 | 12 | - | - | 54 |
| Total | $54,882 | $3,324 | $3,458 | $- | $61,664 |

As of December 31, 2011, and based on the most recent analysis performed during the month of December 2011, the recorded investment in each risk category of loans by class of loan is as follows:

| | Credit Quality of Loans by Class as of December 31, 2011 | | | | |
|---|---|---|---|---|---|
| ($ in thousands) | Pass | Special Mention | Substandard | Doubtful | Total |
| CRE – owner occupied | $14,068 | $1,135 | $1,134 | $- | $16,337 |
| CRE – non-owner occupied | 15,395 | 1,796 | 1,176 | - | 18,367 |
| Commercial and industrial | 5,021 | - | 560 | - | 5,581 |
| Residential real estate | 13,344 | - | 664 | - | 14,008 |
| Construction and land development | 232 | - | 1,075 | - | 1,307 |
| Consumer | 45 | - | - | - | 45 |
| Total | $48,105 | $2,931 | $4,609 | $- | $55,645 |

NOTE 6 - BANK-OWNED LIFE INSURANCE

During the first quarter of 2012, the Company invested $2.0 million in bank-owned life insurance on certain key employees.  Bank-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value.  Increases in the cash surrender value are recognized as other noninterest income.

NOTE 7 - DEPOSITS

Deposits are summarized as follows:

| ($ in thousands) | September 30, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Amount | % of Total | Amount | % of Total |
| Noninterest-bearing demand | $2,958 | 2 % | $3,550 | 3 % |
| Interest-bearing demand | 8,299 | 7 | 9,355 | 8 |
| Money market accounts | 10,873 | 9 | 9,781 | 8 |
| Savings accounts | 45,646 | 36 | 49,073 | 41 |
| Time deposits, less than $100,000 | 4,574 | 4 | 5,193 | 4 |
| Time deposits, $100,000 or more | 53,120 | 42 | 42,032 | 36 |
| Total deposits | $125,470 | 100 % | $118,984 | 100 % |

In the ordinary course of business, certain officers, directors, stockholders, and employees of the Bank have deposits with the Bank.  In the Bank’s opinion, all deposit relationships with such parties are made on substantially the same terms including interest rates and maturities, as those prevailing at the time for comparable transactions with other persons.  The balances of related party deposits were approximately $3.2 million and $4.3 million at September 30, 2012 and December 31, 2011, respectively.

NOTE 8 — STOCK-BASED COMPENSATION

On September 20, 2012, the Board of Directors adopted the Company's 2012 Long-Term Incentive Plan, (the "2012 Plan"). Under the terms of the 2012 Plan, the Company may grant incentive stock options, nonqualified stock options, restricted stock awards, and/or stock appreciation rights to eligible persons, including officers and directors of the Company. The 2012 Plan reserves 250,000 shares of common stock of the Company for issuance and does not terminate or amend the Company's 2007 Stock Incentive Plan (the "2007 Plan"). As of September 30, 2012, there were no grants made under the 2012 Plan.

Under the terms of the Company's 2007 Plan, employees may be granted both nonqualified and incentive stock options and directors and other consultants, who are not also officers or employees, may only be granted nonqualified stock options. The Board reserved approximately 510,700 shares of common stock for issuance under the 2007 Plan. Of that, 481,270 are issued and outstanding, leaving 29,430 available for future grants as of September 30, 2012. The 2007 Plan provides for options to purchase shares of common stock at a price not less than 100% of the fair market value of the stock on the date of grant. Stock options expire no later than ten years from the date of the grant and generally vest over four years. The 2007 Plan provides for accelerated vesting if there is a change of control, as defined in the 2007 Plan. The Company recognized stock-based compensation cost of approximately $13,000 and $43,000 during the three months ended September 30, 2012 and 2011, respectively and $38,000 and $158,000 during the nine months ended September 30, 2012 and 2011, respectively. No tax benefit related to stock-based compensation will be recognized until the Company demonstrates an ability to maintain profitability.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes-Merton option pricing model. The Company did not grant any options during the third quarter 2012.

During the three months ended September 30, 2012, no options were forfeited and 1,302 vested options expired unexercised. During the third quarter 2011, 2,583 options were forfeited and no vested options expired unexercised. No options were exercised during the three or nine months ended September 30, 2012 or 2011. The Company recognized expense for approximately 13,000 options, representing a pro-rata amount of the options earned during the third quarter of 2012 that are expected to vest. As of September 30, 2012, there was approximately $84,000 of total unrecognized compensation cost related to the outstanding stock options that will be recognized over a weighted-average period of 1.8 years.

The following is a summary of the Company's outstanding stock options and related activity for the nine months ended September 30, 2012:

| | Options | Weighted-Average Grant Date Fair Value | Weighted-Average Exercise Price |
|---|---|---|---|
| Outstanding at December 31, 2011 | 400,312 | $ 1.93 | $ 7.61 |
| Granted | 93,250 | 0.63 | 3.38 |
| Exercised | - | - | - |
| Forfeited | (4,948) | 0.60 | 3.15 |
| Expired | (7,344) | 1.79 | 7.95 |
| Outstanding at September 30, 2012 | 481,270 | $ 1.69 | $ 6.84 |

The following is a summary of the Company's outstanding stock options and related activity for the nine months ended September 30, 2011:

| | Options | Weighted-Average Grant Date Fair Value | Weighted-Average Exercise Price |
|---|---|---|---|
| Outstanding at December 31, 2010 | 367,790 | $ 2.43 | $ 8.31 |
| Granted | 55,500 | 0.62 | 3.00 |
| Exercised | - | - | - |
| Forfeited | (16,603) | 2.11 | 8.30 |
| Expired | (1,000) | 1.32 | 5.90 |
| Outstanding at September 30, 2011 | 405,687 | $ 1.92 | $ 7.59 |

NOTE 9 — NONINTEREST EXPENSE

The following table details the items comprising other general and administrative expenses:

| ($ in thousands) | Three Months Ended September 30, 2012 | 2011 | Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|---|---|
| Other general and administrative expenses: | | | | |
| Data processing | $ 83 | $ 73 | $ 242 | $ 229 |
| FDIC assessment | 33 | 48 | 129 | 165 |
| Regulatory and reporting fees | 30 | 36 | 103 | 119 |
| Marketing and promotions | 46 | 23 | 94 | 64 |
| Directors’ fees | 27 | 22 | 69 | 68 |
| Loan and collection expenses | 11 | 41 | 63 | 76 |