

SHORE BANCSHARES INC  
Form 10-Q  
November 12, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

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

For the Quarterly Period Ended September 30, 2014

**OR**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

Maryland  
(State or Other Jurisdiction of

52-1974638  
(I.R.S. Employer

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Incorporation or Organization)	Identification No.)
28969 Information Lane, Easton, Maryland (Address of Principal Executive Offices)	21601 (Zip Code)

(410) 763-7800

Registrant's Telephone Number, Including Area Code

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes R No

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

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

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

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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 12,614,943 shares of common stock outstanding as of October 31, 2014.

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**PART I – FINANCIAL INFORMATION**

## Item 1. Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share amounts)

	September 30, 2014 (Unaudited)	December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$ 26,879	\$ 21,238
Interest-bearing deposits with other banks	79,045	109,384
Federal funds sold	3,715	468
Investment securities:		
Available for sale, at fair value	223,273	147,101
Held to maturity, at amortized cost – fair value of \$4,754 (2014) and \$5,062 (2013)	4,732	5,185
Loans held for sale	-	3,521
Loans	705,042	711,919
Less: allowance for credit losses	(8,606 )	(10,725 )
Loans, net	696,436	701,194
Premises and equipment, net	15,229	15,198
Goodwill	11,931	12,454
Other intangible assets, net	1,364	3,520
Other real estate owned, net	4,799	3,779
Other assets	28,882	31,082
<b>TOTAL ASSETS</b>	<b>\$ 1,096,285</b>	<b>\$ 1,054,124</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$ 190,197	\$ 172,797
Interest-bearing	750,455	760,671
Total deposits	940,652	933,468
Short-term borrowings	10,755	10,140
Other liabilities	6,204	7,217
<b>TOTAL LIABILITIES</b>	<b>957,611</b>	<b>950,825</b>
<b>STOCKHOLDERS' EQUITY</b>		
	126	85

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Common stock, par value \$.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 12,614,943 (2014) and 8,471,289 (2013)		
Additional paid in capital	63,524	32,207
Retained earnings	75,269	71,444
Accumulated other comprehensive loss	(245 )	(437 )
TOTAL STOCKHOLDERS' EQUITY	138,674	103,299
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 1,096,285	\$ 1,054,124

See accompanying notes to Consolidated Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

(Dollars in thousands, except per share amounts)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 8,788	\$ 9,767	\$ 26,475	\$ 29,816
Interest and dividends on investment securities:				
Taxable	850	357	2,040	1,568
Tax-exempt	3	5	9	14
Interest on federal funds sold	1	-	1	3
Interest on deposits with other banks	44	53	139	143
Total interest income	9,686	10,182	28,664	31,544
<b>INTEREST EXPENSE</b>				
Interest on deposits	1,046	1,348	3,244	5,218
Interest on short-term borrowings	4	6	14	20
Total interest expense	1,050	1,354	3,258	5,238
<b>NET INTEREST INCOME</b>				
Provision for credit losses	775	22,460	2,700	27,310
<b>NET INTEREST INCOME (EXPENSE) AFTER PROVISION FOR CREDIT LOSSES</b>				
	7,861	(13,632 )	22,706	(1,004 )
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	618	600	1,778	1,772
Trust and investment fee income	496	401	1,382	1,184
Gains on sales of investment securities	-	-	-	913
Insurance agency commissions	2,176	2,724	7,789	8,170
Loss on termination of cash flow hedge	-	-	-	(1,306 )
Other noninterest income	704	1,067	2,361	2,511
Total noninterest income	3,994	4,792	13,310	13,244
<b>NONINTEREST EXPENSE</b>				
Salaries and wages	4,689	4,420	13,295	13,010
Employee benefits	934	971	3,136	3,111
Occupancy expense	565	566	1,769	1,775
Furniture and equipment expense	225	275	741	768
Data processing	741	718	2,240	2,127



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Directors' fees	131	86	375	262
Amortization of other intangible assets	34	74	168	222
Insurance agency commissions expense	-	409	906	1,328
FDIC insurance premium expense	399	467	1,234	1,200
Write-downs of other real estate owned	290	219	466	947
Other noninterest expenses	1,811	1,763	5,521	5,468
Total noninterest expense	9,819	9,968	29,851	30,218
<b>INCOME (LOSS) BEFORE INCOME TAXES (BENEFIT)</b>	<b>2,036</b>	<b>(18,808 )</b>	<b>6,165</b>	<b>(17,978 )</b>
Income tax expense (benefit)	774	(7,416 )	2,340	(7,169 )
<b>NET INCOME (LOSS)</b>	<b>\$ 1,262</b>	<b>\$ (11,392 )</b>	<b>\$ 3,825</b>	<b>\$ (10,809 )</b>
Basic net income per common share	\$ 0.10	\$ (1.35 )	\$ 0.37	\$ (1.28 )
Diluted net income per common share	\$ 0.10	\$ (1.35 )	\$ 0.37	\$ (1.28 )
Dividends paid per common share	\$ -	\$ -	\$ -	\$ -

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)

(Dollars in thousands)

	For the Three Months Ended September 30, 2014		For the Nine Months Ended September 30, 2014	
	2013		2013	
Net income (loss)	\$ 1,262	\$ (11,392 )	\$ 3,825	\$ (10,809 )
Other comprehensive income (loss)				
Securities available for sale:				
Unrealized holding gains (losses) on available-for-sale securities	(181 )	(367 )	322	(3,167 )
Tax effect	73	148	(130 )	1,278
Reclassification of gains recognized in net income	-	-	-	(913 )
Tax effect	-	-	-	368
Net of tax amount	(108 )	(219 )	192	(2,434 )
Cash flow hedging activities:				
Unrealized holding gains on cash flow hedging activities	-	-	-	681
Tax effect	-	-	-	(274 )
Reclassification of losses recognized in net income	-	-	-	1,306
Tax effect	-	-	-	(527 )
Net of tax amount	-	-	-	1,186
Total other comprehensive income (loss)	(108 )	(219 )	192	(1,248 )
Comprehensive income (loss)	\$ 1,154	\$ (11,611 )	\$ 4,017	\$ (12,057 )

See accompanying notes to Consolidated Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)

For the Nine Months Ended September 30, 2014 and 2013

(Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2014	\$ 85	\$ 32,207	\$ 71,444	\$ (437	) \$ 103,299
Net income	-	-	3,825	-	3,825
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	192	192
Issuance of common stock through public offering, net	41	31,238	-	-	31,279
Stock-based compensation	-	79	-	-	79
Balances, September 30, 2014	\$ 126	\$ 63,524	\$ 75,269	\$ (245	) \$ 138,674
Balances, January 1, 2013	\$ 85	\$ 32,155	\$ 81,078	\$ 708	\$ 114,026
Net loss	-	-	(10,809)	-	(10,809 )
Unrealized losses on available-for-sale securities, net of taxes	-	-	-	(2,434	) (2,434 )
Unrealized gains on cash flow hedging activities, net of taxes	-	-	-	1,186	1,186
Stock-based compensation	-	32	-	-	32
Balances, September 30, 2013	\$ 85	\$ 32,187	\$ 70,269	\$ (540	) \$ 102,001

See accompanying notes to Consolidated Financial Statements.



## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(Dollars in thousands)

	For the Nine Months Ended September 30,	
	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 3,825	\$ (10,809 )
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	2,700	27,310
Depreciation and amortization	1,725	1,839
Discount accretion on debt securities	(41 )	(30 )
Stock-based compensation expense	79	58
Excess tax benefit from stock-based arrangements	-	(26 )
Deferred income tax expense	1,923	286
Gains on sales of investment securities	-	(913 )
Losses on sales of other real estate owned	3	241
Write-downs of other real estate owned	466	947
Gain on sale of wholesale insurance subsidiary	(114 )	-
Loss on termination of cash flow hedge	-	1,306
Net changes in:		
Accrued interest receivable	(79 )	27
Other assets	(204 )	(8,561 )
Accrued interest payable	(26 )	(68 )
Other liabilities	(985 )	(1,220 )
Net cash provided by operating activities	9,272	10,387
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from maturities and principal payments of investment securities available for sale	35,473	27,518
Proceeds from sales of investment securities available for sale	-	40,351
Purchases of investment securities available for sale	(111,949 )	(62,049 )
Proceeds from maturities and principal payments of investment securities held to maturity	443	294
Net change in loans	3,354	7,963
Purchases of premises and equipment	(736 )	(292 )
Proceeds from sales of premises and equipment	-	4
Proceeds from sales of other real estate owned	734	3,595
Proceeds from sale of wholesale insurance subsidiary	2,878	-
Return of investment in unconsolidated subsidiary	-	85
Net cash (used in) provided by investing activities	(69,803 )	17,469
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		

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Net changes in:		
Noninterest-bearing deposits	17,402	12,233
Interest-bearing deposits	(10,216 )	(131,093 )
Short-term borrowings	615	(2,293 )
Proceeds from issuance of common stock through public offering, net	31,279	-
Excess tax benefit from stock-based arrangements	-	26
Net cash provided by (used in) financing activities	39,080	(121,127 )
Net decrease in cash and cash equivalents	(21,451 )	(93,271 )
Cash and cash equivalents at beginning of period	131,090	200,193
Cash and cash equivalents at end of period	\$ 109,639	\$ 106,922
Supplemental cash flows information:		
Interest paid	\$ 3,284	\$ 5,307
Income taxes paid	\$ 85	\$ 265
Transfers from loans to other real estate owned	\$ 2,224	\$ 2,857
Transfers from loans to loans held for sale	\$ -	\$ 23,635
Transfers from loans held for sale to loans	\$ 3,521	\$ -

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.

Notes to Consolidated Financial Statements

For the Three and Nine Months Ended September 30, 2014 and 2013

(Unaudited)

#### Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America (“GAAP”) and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at September 30, 2014, the consolidated results of operations and comprehensive income (loss) for the three and nine months ended September 30, 2014 and 2013, and changes in stockholders’ equity and cash flows for the nine months ended September 30, 2014 and 2013, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2013 were derived from the 2013 audited financial statements. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2013. For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

When used in these notes, the term “the Company” refers to Shore Bancshares, Inc. and, unless the context requires otherwise, its consolidated subsidiaries.

#### Recent Accounting Standards

*Accounting Standards Update (“ASU”) 2013-04, “Liabilities (Accounting Standards Codification (“ASC”) Topic 405) - Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date.”* ASU 2013-04 provides guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. This guidance requires an entity to measure the obligation as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors, and any additional amount the reporting entity expects to pay on behalf of its co-obligors. This guidance also requires an entity to disclose the nature and amount of the obligation as well as other information about those obligations. ASU 2013-04 became effective for the Company on January 1, 2014, and did not have a significant impact on the Company’s

financial statements.

*ASU 2014-04, "Receivables (ASC Topic 310) – Troubled Debt Restructurings by Creditors, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure."* ASU 2014-04 clarifies when an in substance repossession or foreclosure occurs which is defined as when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU requires that the real property be recognized upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 is effective for the Company for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on the Company's financial statements.

*Accounting Standards Update ("ASU") 2014-14, "Receivables – Troubled Debt Restructurings by Creditors (Accounting Standards Codification ("ASC") Subtopic 310-40) – Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure."* ASU 2014-14 the FASB issued an amendment to clarify how creditors are to classify certain government-guaranteed mortgage loans upon foreclosure. This amendment requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separate from the loan before foreclosure and (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under the claim and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This amendment is effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. Entities may apply the amendments in this Update either (a) prospectively to foreclosures that occur after the date of adoption or (b) modified retrospective transition using a cumulative-effect adjustment (through a reclassification to a separate other receivable) as of the beginning of the annual period of adoption. Prior periods should not be adjusted. The Company intends to adopt the accounting standard during the first quarter of 2015, as required, and is currently evaluating the impact on its results of operations, financial position, and liquidity.



Note 2 – Earnings Per Share

Basic earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents (stock-based awards). The following table provides information relating to the calculation of earnings per common share:

(In thousands, except per share data)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income (loss)	\$ 1,262	\$ (11,392 )	\$ 3,825	\$ (10,809 )
Weighted average shares outstanding - Basic	12,615	8,461	10,381	8,460
Dilutive effect of common stock equivalents	10	-	12	-
Weighted average shares outstanding - Diluted	12,625	8,461	10,393	8,460
Earnings (loss) per common share - Basic	\$ 0.10	\$ (1.35 )	\$ 0.37	\$ (1.28 )
Earnings (loss) per common share - Diluted	\$ 0.10	\$ (1.35 )	\$ 0.37	\$ (1.28 )

The increase in the weighted average shares outstanding for the three and nine months ended September 30, 2014 when compared to the three and nine months ended September 30, 2013 was due to the Company's public offer and sale of its common stock (the "stock sale") during the second quarter of 2014. As a result of the stock sale, the Company sold 4,140,000 shares of its common stock for a price of \$8.25 per share, which produced net proceeds of \$31.3 million.

There were no weighted average common stock equivalents excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2014. There were 54 thousand weighted average common stock equivalents excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2013 because the effect of including them would have been antidilutive.

Note 3 – Investment Securities

The following table provides information on the amortized cost and estimated fair values of investment securities.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
September 30, 2014				
U.S. Treasury	\$ 5,243	\$ 8	\$ -	\$ 5,251
U.S. Government agencies	62,359	65	227	62,197
Mortgage-backed Equity	155,462 620	547 2	806 -	155,203 622
Total	\$ 223,684	\$ 622	\$ 1,033	\$ 223,273
December 31, 2013				
U.S. Treasury	\$ 5,342	\$ 1	\$ -	\$ 5,343
U.S. Government agencies	60,754	62	372	60,444
Mortgage-backed Equity	81,130 609	520 -	937 8	80,713 601
Total	\$ 147,835	\$ 583	\$ 1,317	\$ 147,101
Held-to-maturity securities:				
September 30, 2014				
U.S. Government agencies	\$ 2,792	\$ -	\$ 134	\$ 2,658
States and political subdivisions	1,940	156	-	2,096
Total	\$ 4,732	\$ 156	\$ 134	\$ 4,754
December 31, 2013				
U.S. Government agencies	\$ 2,975	\$ -	\$ 222	\$ 2,753
States and political subdivisions	2,210	99	-	2,309
Total	\$ 5,185	\$ 99	\$ 222	\$ 5,062

The following tables provide information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at September 30, 2014 and December 31, 2013.

(Dollars in thousands)	Less than		More than		Total	
	12 Months		12 Months		Fair Value	Unrealized Losses
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		
September 30, 2014						
Available-for-sale securities:						
U.S. Government agencies	\$30,686	\$ 36	\$9,979	\$ 191	\$40,665	\$ 227
Mortgage-backed	74,621	323	22,841	483	97,462	806
Total	\$105,307	\$ 359	\$32,820	\$ 674	\$138,127	\$ 1,033
Held-to-maturity securities:						
U.S. Government agencies	\$-	\$ -	\$2,658	\$ 134	\$2,658	\$ 134

(Dollars in thousands)	Less than		More than		Total	
	12 Months		12 Months		Fair Value	Unrealized Losses
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		
December 31, 2013						
Available-for-sale securities:						
U.S. Government agencies	\$33,004	\$ 372	\$-	\$ -	\$33,004	\$ 372
Mortgage-backed	28,694	416	19,121	521	47,815	937
Equity	601	8	-	-	601	8
Total	\$62,299	\$ 796	\$19,121	\$ 521	\$81,420	\$ 1,317
Held-to-maturity securities:						
U.S. Government agencies	\$2,753	\$ 222	\$-	\$ -	\$2,753	\$ 222

All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary.

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The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at September 30, 2014.

(Dollars in thousands)	Available for sale		Held to maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$-	\$-	\$222	\$ 225
Due after one year through five years	64,148	64,149	210	220
Due after five years through ten years	8,871	8,898	1,005	1,119
Due after ten years	150,045	149,604	3,295	3,190
	223,064	222,651	4,732	4,754
Equity securities	620	622	-	-
Total	\$223,684	\$ 223,273	\$4,732	\$ 4,754

The maturity dates for debt securities are determined using contractual maturity dates.

Note 4 – Loans and Allowance for Credit Losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne’s County, Kent County, Caroline County and Dorchester County in Maryland and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at September 30, 2014 and December 31, 2013. At December 31, 2013, \$3.5 million of nonaccrual construction loans were classified as held for sale. During the first quarter of 2014, these loans held for sale were reclassified to loans.

(Dollars in thousands)	September 30, 2014	December 31, 2013
Construction	\$ 67,366	\$ 64,591
Residential real estate	276,441	274,857
Commercial real estate	297,847	304,605
Commercial	54,207	57,195
Consumer	9,181	10,671
Total loans	705,042	711,919
Allowance for credit losses	(8,606 )	(10,725 )
Total loans, net	\$ 696,436	\$ 701,194

Loans are stated at their principal amount outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual (i.e., interest income is no longer accrued) when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan’s contractual terms. An impaired loan may show deficiencies in the borrower’s overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan’s effective interest rate, or at the loan’s observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the amount of impairment has been determined, the uncollectible portion is charged off. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired

loans. Specific reserves remain until charge offs are made. Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses. See additional discussion under the caption “Critical Accounting Policies” in Management’s Discussion and Analysis of Financial Condition and Results of Operations.

A loan is considered a troubled debt restructuring (“TDR”) if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Loans are identified to be restructured when signs of impairment arise such as borrower interest rate reduction request, slowness to pay, or when an inability to repay becomes evident. The terms being offered are evaluated to determine if they are more liberal than those that would be indicated by policy or industry standards for similar, untroubled credits. In those situations where the terms or the interest rates are considered to be more favorable than industry standards or the current underwriting guidelines of the Company’s banking subsidiaries, the loan is classified as a TDR. All loans designated as TDRs are considered impaired loans and may be on either accrual or nonaccrual status. In instances where the loan has been placed on nonaccrual status, six consecutive months of timely payments are required prior to returning the loan to accrual status.

All loans classified as TDRs which are restructured and accrue interest under revised terms require a full and comprehensive review of the borrower’s financial condition, capacity for repayment, realistic assessment of collateral values, and the assessment of risk entered into any workout agreement. Current financial information on the borrower, guarantor, and underlying collateral is analyzed to determine if it supports the ultimate collection of principal and interest. For commercial loans, the cash flows are analyzed, both for the underlying project and globally. For consumer loans, updated salary, credit history and cash flow information is obtained. Current market conditions are also considered. Following a full analysis, the determination of the appropriate loan structure is made.

The following tables include impairment information relating to loans and the allowance for credit losses as of September 30, 2014 and December 31, 2013.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
September 30, 2014							
Loans individually evaluated for impairment	\$ 10,404	\$ 18,599	\$ 8,322	\$ 517	\$ 124	\$ -	\$ 37,966
Loans collectively evaluated for impairment	56,962	257,842	289,525	53,690	9,057	-	667,076
Total loans	\$ 67,366	\$ 276,441	\$ 297,847	\$ 54,207	\$ 9,181	\$ -	\$ 705,042
Allowance for credit losses allocated to:							
Loans individually evaluated for impairment	\$ 201	\$ 243	\$ 6	\$ 293	\$ 25	\$ -	\$ 768
Loans collectively evaluated for impairment	1,629	2,145	2,735	505	243	581	7,838
Total allowance for credit losses	\$ 1,830	\$ 2,388	\$ 2,741	\$ 798	\$ 268	\$ 581	\$ 8,606
December 31, 2013							
Loans individually evaluated for impairment	\$ 5,569	\$ 19,748	\$ 14,462	\$ 887	\$ 48	\$ -	\$ 40,714
Loans collectively evaluated for impairment	59,022	255,109	290,143	56,308	10,623	-	671,205
Total loans	\$ 64,591	\$ 274,857	\$ 304,605	\$ 57,195	\$ 10,671	\$ -	\$ 711,919
Allowance for credit losses allocated to:							
Loans individually evaluated for impairment	\$ 204	\$ 285	\$ 44	\$ 245	\$ 5	\$ -	\$ 783
Loans collectively evaluated for impairment	1,756	3,569	2,985	1,021	238	373	9,942
Total allowance for credit losses	\$ 1,960	\$ 3,854	\$ 3,029	\$ 1,266	\$ 243	\$ 373	\$ 10,725

The following tables provide information on impaired loans and any related allowance by loan class as of September 30, 2014 and December 31, 2013. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken.

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to-date average recorded investment	Year-to-date average recorded investment
September 30, 2014						
Impaired nonaccrual loans:						
Construction	\$ 10,542	\$ 6,801	\$ 200	\$ 200	\$ 7,492	\$ 7,918
Residential real estate	3,191	2,300	73	75	2,604	4,014
Commercial real estate	4,557	2,756	-	-	3,132	4,443
Commercial	1,680	167	298	293	389	558
Consumer	129	99	25	25	124	55
Total	20,099	12,123	596	593	13,741	16,988
Impaired accruing TDRs:						
Construction	3,403	3,316	87	1	3,404	2,301
Residential real estate	16,226	12,813	3,413	168	16,190	16,131
Commercial real estate	5,566	4,799	767	6	5,459	6,826
Commercial	52	52	-	-	54	62
Consumer	-	-	-	-	-	-
Total	25,247	20,980	4,267	175	25,107	25,320
Total impaired loans:						
Construction	13,945	10,117	287	201	10,896	10,219
Residential real estate	19,417	15,113	3,486	243	18,794	20,145
Commercial real estate	10,123	7,555	767	6	8,591	11,269
Commercial	1,732	219	298	293	443	620
Consumer	129	99	25	25	124	55
Total	\$ 45,346	\$ 33,103	\$ 4,863	\$ 768	\$ 38,848	\$ 42,308



(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to-date average recorded investment	Year-to-date average recorded investment
December 31, 2013						
Impaired nonaccrual loans:						
Construction	\$ 6,787	\$ 3,709	\$ 240	\$ 203	\$ 5,563	\$ 7,270
Residential real estate	7,692	3,862	1,304	225	5,094	10,240
Commercial real estate	5,218	4,261	410	38	3,917	7,829
Commercial	1,801	547	245	245	740	619
Consumer	56	43	5	5	49	48
Total	21,554	12,422	2,204	716	15,363	26,006
Impaired accruing TDRs:						
Construction	1,620	1,527	93	1	1,759	14,405
Residential real estate	14,582	13,177	1,405	60	15,387	11,101
Commercial real estate	9,791	9,006	785	6	10,201	13,308
Commercial	95	95	-	-	98	105
Consumer	-	-	-	-	-	-
Total	26,088	23,805	2,283	67	27,445	38,919
Total impaired loans:						
Construction	8,407	5,236	333	204	7,322	21,675
Residential real estate	22,274	17,039	2,709	285	20,481	21,341
Commercial real estate	15,009	13,267	1,195	44	14,118	21,137
Commercial	1,896	642	245	245	838	724
Consumer	56	43	5	5	49	48
Total	\$ 47,642	\$ 36,227	\$ 4,487	\$ 783	\$ 42,808	\$ 64,925

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The following tables provide a roll-forward for troubled debt restructurings as of September 30, 2014 and September 30, 2013.

(Dollars in thousands)	12/31/13 TDR Balance	New TDRs	Disbursements (Payments)	Charge offs	Reclassification Transfers In(Out)	9/30/2014 Loan Sale	Payoffs	9/30/14 TDR Balance	Related Allowance
For the nine months ended 9/30/2014									
Accruing TDRs									
Construction	\$ 1,620	\$ -	\$ (52 )	\$ (538 )	\$ 2,643	\$ -	\$ (270 )	\$ 3,403	\$ 1
Residential Real Estate	14,582	-	1,324	-	478	-	(158 )	16,226	168
Commercial Real Estate	9,791	-	(71 )	(549 )	(2,508 )	-	(1,097)	5,566	6
Commercial	95	-	(19 )	-	-	-	(24 )	52	-
Consumer	-	-	-	-	-	-	-	-	-
Total	\$ 26,088	\$ -	\$ 1,182	\$ (1,087)	\$ 613	\$ -	\$ (1,549)	\$ 25,247	\$ 175
Nonaccrual TDRs									
Construction	\$ 3,561	\$ -	\$ (12 )	\$ (235 )	\$ 760	\$ -	\$ -	\$ 4,074	\$ -
Residential Real Estate	1,884	-	(40 )	(203 )	(1,037 )	-	(123 )	481	-
Commercial Real Estate	842	-	(91 )	(65 )	(336 )	-	-	350	-
Commercial	-	-	-	-	-	-	-	-	-
Consumer	26	-	(1 )	-	-	-	-	25	25
Total	\$ 6,313	\$ -	\$ (144 )	\$ (503 )	\$ (613 )	\$ -	\$ (123 )	\$ 4,930	\$ 25
Total TDRs	\$ 32,401	\$ -	\$ 1,038	\$ (1,590)	\$ -	\$ -	\$ (1,672)	\$ 30,177	\$ 200

(Dollars in thousands)	12/31/12 TDR Balance	New TDRs	Disbursements (Payments)	Charge offs	Reclassification Transfers In(Out)	9/30/2013 Loan Sale	Payoffs	9/30/13 TDR Balance	Related Allowance
For the nine months ended 9/30/2013									
Accruing TDRs									
Construction	\$ 27,335	\$ 218	\$ 71	\$ (13,557 )	\$ (3,521 )	\$ (7,908 )	\$ (739 )	\$ 1,899	\$ 1
Residential Real Estate	7,017	11,514	166	(218 )	(1,349 )	(395 )	-	16,735	584
Commercial Real Estate	17,880	2,211	(55 )	(2,062 )	-	(7,162 )	(108 )	10,704	92
Commercial	121	-	(20 )	-	-	-	-	101	-
Consumer	-	-	-	-	-	-	-	-	-
Total	\$ 52,353	\$ 13,943	\$ 162	\$ (15,837 )	\$ (4,870 )	\$ (15,465 )	\$ (847 )	\$ 29,439	\$ 677
Nonaccrual TDRs									
Construction	\$ 1,448	\$ -	\$ (62 )	\$ (612 )	\$ 3,521	\$ (57 )	\$ (368 )	\$ 3,870	\$ 25
Residential Real Estate	2,169	258	(75 )	(1,218 )	1,349	(759 )	(126 )	1,598	-
Commercial Real Estate	2,970	-	(274 )	(866 )	-	-	(1,391)	439	-

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Commercial	-	-	-	-	-	-	-	-	-
Consumer	27	-	(1 )	-	-	-	-	26	26
Total	\$6,614	\$258	\$(412 )	\$(2,696 )	\$4,870	\$(816 )	\$(1,885)	\$5,933	\$51
Total TDRs	\$58,967	\$14,201	\$(250 )	\$(18,533 )	\$-	\$(16,281 )	\$(2,732)	\$35,372	\$728

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The following tables provide information on loans that were modified and considered TDRs during the nine months ended September 30, 2014 and September 30, 2013.

(Dollars in thousands)	Number of contracts	Premodification outstanding recorded investment	Postmodification outstanding recorded investment	Related allowance
TDRs:				
For the nine months ended September 30, 2014				
Construction	-	\$ -	\$ -	\$ -
Residential real estate	-	-	-	-
Commercial real estate	-	-	-	-
Commercial	-	-	-	-
Consumer	-	-	-	-
Total	-	\$ -	\$ -	\$ -
For the nine months ended September 30, 2013				
Construction	3	\$ 218	\$ 218	\$ -
Residential real estate	6	11,758	11,772	38
Commercial real estate	4	2,212	2,211	82
Commercial	-	-	-	-
Consumer	-	-	-	-
Total	13	\$ 14,188	\$ 14,201	\$ 120

The following tables provide information on TDRs that defaulted during the nine months ended September 30, 2014 and September 30, 2013. Generally, a loan is considered in default when principal or interest is past due 90 days or more.

(Dollars in thousands)	Number of contracts	Recorded investment	Related allowance
TDRs that subsequently defaulted (1):			
For the nine months ended September 30, 2014			
Construction	-	\$ -	\$ -
Residential real estate	-	-	-
Commercial real estate	-	-	-
Commercial	-	-	-
Consumer	-	-	-
Total	-	\$ -	\$ -

TDRs that subsequently defaulted (2):  
For the nine months ended September 30, 2013

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Construction	-	\$ -	\$ -
Residential real estate	4	1,563	-
Commercial real estate	1	1,741	74
Commercial	-	-	-
Consumer	-	-	-
Total	5	\$ 3,304	\$ 74

(1) These loans were classified as TDRs during 2013.

(2) These loans were classified as TDRs during 2012.

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. They are assigned higher risk ratings than favorably rated loans in the calculation of the formula portion of the allowance for credit losses.

The following tables provide information on loan risk ratings as of September 30, 2014 and December 31, 2013.

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Total
September 30, 2014					
Construction	\$ 45,937	\$ 9,668	\$ 11,761	\$ -	\$ 67,366
Residential real estate	247,438	16,476	12,437	90	276,441
Commercial real estate	266,039	20,775	11,033	-	297,847
Commercial	51,126	2,450	252	379	54,207
Consumer	9,040	18	123	-	9,181
Total	\$ 619,580	\$ 49,387	\$ 35,606	\$ 469	\$ 705,042

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Total
December 31, 2013					
Construction	\$ 39,268	\$ 15,884	\$ 9,439	\$ -	\$ 64,591
Residential real estate	235,054	22,638	17,114	51	274,857
Commercial real estate	255,280	30,105	19,210	10	304,605
Commercial	52,032	3,691	972	500	57,195
Consumer	10,451	48	172	-	10,671
Total	\$ 592,085	\$ 72,366	\$ 46,907	\$ 561	\$ 711,919

The following tables provide information on the aging of the loan portfolio as of September 30, 2014 and December 31, 2013.

(Dollars in thousands)	Accruing	Accruing			Total past due	Nonaccrual	Total
		Current	30-59 days past due	60-89 days past due			
September 30, 2014							
Construction	\$ 59,106	\$ 1,259	\$ -	\$ -	\$ 1,259	\$ 7,001	\$ 67,366
Residential real estate	270,851	2,142	1,074	-	3,216	2,374	276,441
Commercial real estate	293,827	243	1,021	-	1,264	2,756	297,847
Commercial	53,434	196	112	-	308	465	54,207
Consumer	8,998	57	3	-	60	123	9,181
Total	\$ 686,216	\$ 3,897	\$ 2,210	\$ -	\$ 6,107	\$ 12,719	\$ 705,042

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Percent of total loans 97.3 % 0.6 % 0.3 % - % 0.9 % 1.8 %

(Dollars in thousands)	Accruing				Total past due	Nonaccrual	Total
	Current	30-59 days past due	60-89 days past due	90 days or more past due			
December 31, 2013							
Construction	\$60,642	\$ -	\$ -	\$ -	\$ -	\$ 3,949	\$64,591
Residential real estate	265,182	2,765	1,724	20	4,509	5,166	274,857
Commercial real estate	299,295	639	-	-	639	4,671	304,605
Commercial	55,576	330	247	250	827	792	57,195
Consumer	10,469	23	131	-	154	48	10,671
Total	\$691,164	\$ 3,757	\$ 2,102	\$ 270	\$ 6,129	\$ 14,626	\$711,919
Percent of total loans	97.1 %	0.5 %	0.3 %	- %	0.8 %	2.1 %	

Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three months ended September 30, 2014 and 2013. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended September 30, 2014							
Allowance for credit losses:							
Beginning balance	\$ 2,248	\$ 2,354	\$ 2,652	\$ 858	\$ 306	\$ 658	\$9,076
Charge-offs	(213 )	(242 )	(35 )	(1,019 )	(6 )	-	(1,515)
Recoveries	1	229	9	24	7	-	270
Net charge-offs	(212 )	(13 )	(26 )	(995 )	1	-	(1,245)
Provision	(206 )	47	115	935	(39 )	(77 )	775
Ending balance	\$ 1,830	\$ 2,388	\$ 2,741	\$ 798	\$ 268	\$ 581	\$8,606

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended September 30, 2013							
Allowance for credit losses:							
Beginning balance	\$ 4,346	\$ 4,259	\$ 5,514	\$ 1,216	\$ 301	\$ 87	\$15,723
Charge-offs	(18,539 )	(4,225 )	(4,056 )	(196 )	(3 )	-	(27,019)
Recoveries	3	51	20	47	16	-	137
Net charge-offs	(18,536 )	(4,174 )	(4,036 )	(149 )	13	-	(26,882)
Provision	16,180	3,645	2,090	205	(44 )	384	22,460
Ending balance	\$ 1,990	\$ 3,730	\$ 3,568	\$ 1,272	\$ 270	\$ 471	\$11,301



The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the nine months ended September 30, 2014 and 2013.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the nine months ended September 30, 2014							
Allowance for credit losses:							
Beginning balance	\$ 1,960	\$ 3,854	\$ 3,029	\$ 1,266	\$ 243	\$ 373	\$10,725
Charge-offs	(454 )	(1,229 )	(1,648 )	(1,956 )	(153 )	-	(5,440 )
Recoveries	12	335	22	231	21	-	621
Net charge-offs	(442 )	(894 )	(1,626 )	(1,725 )	(132 )	-	(4,819 )
Provision	312	(572 )	1,338	1,257	157	208	2,700
Ending balance	\$ 1,830	\$ 2,388	\$ 2,741	\$ 798	\$ 268	\$ 581	\$8,606

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the nine months ended September 30, 2013							
Allowance for credit losses:							
Beginning balance	\$ 4,387	\$ 5,194	\$ 4,134	\$ 1,682	\$ 407	\$ 187	\$15,991
Charge-offs	(20,048 )	(6,114 )	(6,003 )	(419 )	(65 )	-	(32,649 )
Recoveries	5	349	113	149	33	-	649
Net charge-offs	(20,043 )	(5,765 )	(5,890 )	(270 )	(32 )	-	(32,000 )
Provision	17,646	4,301	5,324	(140 )	(105 )	284	27,310
Ending balance	\$ 1,990	\$ 3,730	\$ 3,568	\$ 1,272	\$ 270	\$ 471	\$11,301

Note 5 – Other Assets

The Company had the following other assets at September 30, 2014 and December 31, 2013.

(Dollars in thousands)	September 30, 2014	December 31, 2013
Nonmarketable investment securities	\$ 1,586	\$ 2,058
Accrued interest receivable	2,640	2,561

Deferred income taxes	16,849	19,090
Prepaid expenses	1,310	700
Other assets	6,497	6,673
Total	\$ 28,882	\$ 31,082

As of September 30, 2014, the Company has a net operating loss-related deferred tax asset (“NOL-DTA”) of \$11.4 million, which will expire in 2034. Should the Company be unable to sustain the current level of taxable income in the future, the Company may be unable to fully realize the NOL-DTA. In addition, the Company could be subject to Section 382 of the Internal Revenue Code (“IRC”), which could further limit the realization of the NOL-DTA. The Company considered the following positive factors in determining the need for a valuation allowance on the NOL-DTA: the Company returned to profitability in 2014; the Company has no plans to enter into stock transactions that would trigger the Section 382 limitation; the Company has no history of an NOL expiring unused. Although the local economy of the market in which the Company operates has been showing continued signs of improvement over the past two years, if this trend flattens or reverses, there is a potential that this negative evidence could outweigh the prevailing positive factors. Based on the considerations above, the Company concluded that it would be more likely than not to realize in the future all of the net deferred tax assets.

Note 6 – Other Liabilities

The Company had the following other liabilities at September 30, 2014 and December 31, 2013.

(Dollars in thousands)	September 30, 2014	December 31, 2013
Accrued interest payable	\$ 199	\$ 225
Other accounts payable	2,172	3,543
Deferred compensation liability	1,486	1,505
Other liabilities	2,347	1,944
Total	\$ 6,204	\$ 7,217

Note 7 - Stock-Based Compensation

As of September 30, 2014, the Company maintained the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (“2006 Equity Plan”) under which it may issue shares of common stock or grant other equity-based awards. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date over a three- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant-date fair value and reflects forfeitures as they occur.

The following tables provide information on stock-based compensation expense for the three and nine months ended September 30, 2014 and 2013.

(Dollars in thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2014	2013	September 30, 2014	2013
Stock-based compensation expense	\$ 30	\$ 18	\$ 79	\$ 58
Excess tax benefit related to stock-based compensation	-	-	-	26

(Dollars in thousands)	September 30,	
	2014	2013
Unrecognized stock-based compensation expense	\$ 92	\$ 112
Weighted average period unrecognized expense is expected to be recognized	<b>1.0 years</b>	1.7 years

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2014.

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	13,930	\$ 8.33
Granted	3,654	9.57
Vested	(3,333 )	8.93
Cancelled	-	-
Nonvested at end of period	14,251	\$ 8.51

The fair value of restricted stock awards that vested during the first nine months of 2014 was \$30 thousand.

The following table summarizes stock option activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2014.

	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of period	40,662	\$ 6.64
Granted	-	-
Exercised	-	-
Expired/Cancelled	-	-
Outstanding at end of period	40,662	\$ 6.64
Exercisable at end of period	20,331	\$ 6.64

At the end of the third quarter of 2014, the aggregate intrinsic value of the options outstanding under the 2006 Equity Plan was \$96 thousand based on the \$9.00 market value per share of the Company's common stock at September 30, 2014. Similarly, the aggregate intrinsic value of the options exercisable was \$48 thousand at September 30, 2014. Since there were no options exercised during the first nine months of 2014 or 2013, there was no intrinsic value associated with stock options exercised and no cash received on exercise of options. At September 30, 2014, the weighted average remaining contract life of options outstanding was 7.5 years.

#### Note 8 – Accumulated Other Comprehensive Income

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale and on cash flow hedging activities as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for the nine months ended September 30, 2014 and 2013.

(Dollars in thousands)	Accumulated net unrealized holding gains (losses) on available for sale securities	Accumulated net unrealized holding gains (losses) on cash flow hedging activities	Total accumulated other comprehensive income (loss)
Balance, December 31, 2013	\$ (437)	) \$ -	\$ (437)
Other comprehensive income	192	-	192
Balance, September 30, 2014	\$ (245)	) \$ -	\$ (245)
Balance, December 31, 2012	\$ 1,894	\$ (1,186)	) \$ 708
Other comprehensive (loss) income	(1,889)	) 407	(1,482)

Reclassification of (gains) losses recognized	(545	)	779	234
Balance, September 30, 2013	\$ (540	)	\$ -	\$ (540 )

Note 9 – Fair Value Measurements

Accounting guidance under GAAP defines fair value as 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. This accounting guidance also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans, loans held for sale and other real estate owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under fair value accounting guidance, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair values. These hierarchy levels are:

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

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Below is a discussion on the Company’s assets measured at fair value on a recurring basis.

Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in U.S. Treasury securities as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at September 30, 2014 and December 31, 2013. No assets were transferred from one hierarchy level to another during the first nine months of 2014 or 2013.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2014				
Securities available for sale:				
U.S. Treasury	\$5,251	\$5,251	\$ -	\$ -
U.S. Government agencies	62,197	-	62,197	-

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Mortgage-backed	155,203	-	155,203	-
Equity	622	-	622	-
Total	\$223,273	\$5,251	\$ 218,022	\$ -

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013				
Securities available for sale:				
U.S. Treasury	\$ 5,343	\$ 5,343	\$ -	\$ -
U.S. Government agencies	60,444	-	60,444	-
Mortgage-backed	80,713	-	80,713	-
Equity	601	-	601	-
Total	\$ 147,101	\$ 5,343	\$ 141,758	\$ -

Below is a discussion on the Company's assets measured at fair value on a nonrecurring basis.



Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with contractual terms. The fair value of impaired loans can be estimated using one of several methods, including the collateral value, market value of similar debt, liquidation value and discounted cash flows. At September 30, 2014 and December 31, 2013, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 2 in the fair value hierarchy.

Loans held for sale

Loans held for sale are adjusted for fair value upon transfer of loans to loans held for sale. Subsequently, loans held for sale are carried at the lower of carrying value or fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At September 30, 2014, the Company had no loans held for sale. At December 31, 2013, loans held for sale were classified as Level 2 in the fair value hierarchy.

Other Real Estate and Other Assets Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At September 30, 2014 and December 31, 2013, foreclosed assets were classified as Level 2 in the fair value hierarchy.

The tables below present the recorded amount of assets measured at fair value on a nonrecurring basis at September 30, 2014 and December 31, 2013. No assets were transferred from one hierarchy level to another during the first nine months of 2014 or 2013.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2014				
Impaired loans				
Construction	\$ 10,203	\$ -	\$ 10,203	\$ -
Residential real estate	18,356	-	18,356	-

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Commercial real estate	8,316	-	8,316	-
Commercial	224	-	224	-
Consumer	99	-	99	-
Total impaired loans	37,198	-	37,198	-
Loans held for sale	-	-	-	-
Other real estate owned	4,799	-	4,799	-
Total assets measured at fair value on a nonrecurring basis	\$ 41,997	\$ -	\$ 41,997	\$ -

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013				
Impaired loans				
Construction	\$5,365	\$ -	\$ 5,365	\$ -
Residential real estate	19,463	-	19,463	-
Commercial real estate	14,418	-	14,418	-
Commercial	642	-	642	-
Consumer	43	-	43	-
Total impaired loans	39,931	-	39,931	-
Loans held for sale	3,521	-	3,521	-
Other real estate owned	3,779	-	3,779	-
Total assets measured at fair value on a nonrecurring basis	\$47,231	\$ -	\$ 47,231	\$ -

The following information relates to the estimated fair values of financial assets and liabilities that are reported in the Company's consolidated balance sheets at their carrying amounts. The discussion below describes the methods and assumptions used to estimate the fair value of each class of financial asset and liability for which it is practicable to estimate that value.

#### Cash and Cash Equivalents

Cash equivalents include interest-bearing deposits with other banks and federal funds sold. For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

#### Investment Securities Held to Maturity

For all investments in debt securities, fair values are based on quoted prices. If a quoted price is not available, then fair value is estimated using quoted prices for similar securities.

#### Loans

The fair values of categories of fixed rate loans, such as commercial loans, residential real estate, and other consumer loans, are estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Other loans, including variable rate loans, are adjusted for differences in loan characteristics.

Financial Liabilities

The fair values of demand deposits, savings accounts, and certain money market deposits are the amounts payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. These estimates do not take into consideration the value of core deposit intangibles. Generally, the carrying amount of short-term borrowings is a reasonable estimate of fair value. The fair values of securities sold under agreements to repurchase (included in short-term borrowings) and long-term debt are estimated using the rates offered for similar borrowings.

Commitments to Extend Credit and Standby Letters of Credit

The majority of the Company's commitments to grant loans and standby letters of credit are written to carry current market interest rates if converted to loans. In general, commitments to extend credit and letters of credit are not assignable by the Company or the borrower, so they generally have value only to the Company and the borrower. Therefore, it is impractical to assign any value to these commitments.

The following table provides information on the estimated fair values of the Company's financial assets and liabilities that are reported in the balance sheets at their carrying amounts. The financial assets and liabilities have been segregated by their classification level in the fair value hierarchy.

(Dollars in thousands)	September 30, 2014		December 31, 2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets</b>				
<b>Level 1 inputs</b>				
Cash and cash equivalents	\$ 109,639	\$ 109,639	\$ 131,090	\$ 131,090
<b>Level 2 inputs</b>				
Investment securities held to maturity	\$ 4,732	\$ 4,754	\$ 5,185	\$ 5,062
Loans, net	696,436	716,187	701,194	721,688
<b>Financial liabilities</b>				
<b>Level 2 inputs</b>				
Deposits	\$ 940,652	\$ 940,505	\$ 933,468	\$ 934,943
Short-term borrowings	10,755	10,755	10,140	10,140

#### Note 10 – Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Company's bank subsidiaries to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding at September 30, 2014 and December 31, 2013.

(Dollars in thousands)	September 30, 2014	December 31, 2013
Commitments to extend credit	\$ 133,085	\$ 116,596
Letters of credit	6,554	10,477
Total	\$ 139,639	\$ 127,073

Note 11 – Segment Reporting

The Company operates two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses on the Eastern Shore of Maryland and Delaware through its 18-branch network. Community banking activities include small business services, retail brokerage, trust services and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life, marine, individual health and long-term care insurance. Pension and profit sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

The following table includes selected financial information by business segments for the first nine months of 2014 and 2013.

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
2014				
Interest income	\$28,664	\$ -	\$ -	\$ 28,664
Interest expense	(3,258 )	-	-	(3,258 )
Provision for credit losses	(2,700 )	-	-	(2,700 )
Noninterest income	4,894	8,416	-	13,310
Noninterest expense	(17,235 )	(6,789 )	(5,827 )	(29,851 )
Net intersegment (expense) income	(4,919 )	(534 )	5,453	-
Income (loss) before taxes	5,446	1,093	(374 )	6,165
Income tax (expense) benefit	(2,067 )	(415 )	142	(2,340 )
Net income (loss)	\$3,379	\$ 678	\$(232 )	\$ 3,825
Total assets	\$ 1,070,991	\$ 10,292	\$ 15,002	\$ 1,096,285
2013				
Interest income	\$31,509	\$ 35	\$ -	\$ 31,544
Interest expense	(5,238 )	-	-	(5,238 )
Provision for credit losses	(27,310 )	-	-	(27,310 )
Noninterest income	4,192	9,046	6	13,244
Noninterest expense	(17,449 )	(7,638 )	(5,131 )	(30,218 )
Net intersegment (expense) income	(3,982 )	(530 )	4,512	-
Income (loss) before taxes	(18,278 )	913	(613 )	(17,978 )
Income tax (expense) benefit	7,289	(364 )	244	7,169
Net income (loss)	\$(10,989 )	\$ 549	\$(369 )	\$(10,809 )
Total assets	\$ 1,032,956	\$ 15,973	\$ 2,455	\$ 1,051,384

## **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.**

Unless the context clearly suggests otherwise, references to “the Company”, “we”, “our”, and “us” in the remainder of this report are to Shore Bancshares, Inc. and its consolidated subsidiaries.

### **Forward-Looking Information**

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words “anticipate”, “estimate”, “should”, “expect”, “believe”, “intend”, and similar expressions, are expressions of our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission (the “SEC”) entitled “Risk Factors” (see Item 1A of Part II of this report and Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2013). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

### **Introduction**

The following discussion and analysis is intended as a review of significant factors affecting the Company’s financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented elsewhere in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2013.

Shore Bancshares, Inc. is the largest independent financial holding company headquartered on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland (“Talbot Bank”) and CNB located in Centreville, Maryland (together with Talbot Bank, the “Banks”). The Banks operate 18 full service branches in Kent County, Queen Anne’s County, Talbot County, Caroline County and Dorchester County in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; and an insurance premium finance company, Mubell Finance, LLC (all of the foregoing are collectively referred to as the “Insurance Subsidiaries”). Each of these entities is a wholly-owned subsidiary of Shore Bancshares, Inc. The Company engages in the trust services business through the trust department at CNB under the trade name Wye Financial & Trust. The Company owned a wholesale insurance company, Tri-State General Insurance Agency, LTD (“TSGIA”), until it was sold on June 6, 2014.



The shares of common stock of Shore Bancshares, Inc. are listed on the NASDAQ Global Select Market under the symbol "SHBI".

Shore Bancshares, Inc. maintains an Internet site at [www.shorebancshares.com](http://www.shorebancshares.com) on which it makes available free of charge its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

### **Regulatory Enforcement Actions**

Talbot Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (the "Consent Agreement") with the Federal Deposit Insurance Corporation (the "FDIC"), a Stipulation and Consent to the Issuance of a Consent Order (the "Maryland Consent Agreement" and together with the Consent Agreement, the "Consent Agreements") with the Maryland Commissioner of Financial Regulation (the "Commissioner") and an Acknowledgement of Adoption of the Order by the Commissioner (the "Acknowledgement"). The FDIC and the Commissioner issued the related Consent Order (the "Order"), effective May 24, 2013. The description of the material terms of the Consent Agreements, the Order and the Acknowledgement, along with Talbot Bank's progress with the requirements of such documents, are set forth below.

**Management.** Talbot Bank is required to have and retain experienced, qualified management, and to assess management's ability to (1) comply with the requirements of the Order; (2) operate Talbot Bank in a safe and sound manner; (3) comply with all applicable laws, rules and regulations; and (4) restore all aspects of Talbot Bank to a safe and sound condition, including capital adequacy, asset quality, and management effectiveness. Talbot Bank has implemented certain changes to comply with the Order, which include expanding its credit administration and loan workout units with the addition of experienced new staff members, in an effort to accelerate the resolution of Talbot Bank's credit issues and position Talbot Bank for future growth. Additionally, Talbot Bank has appointed a chief financial officer.

**Board Participation.** Talbot Bank's board of directors is required to increase its participation in the affairs of Talbot Bank, assuming full responsibility for the approval of sound policies and objectives and for the supervision of all Talbot Bank activities, including comprehensive, documented meetings to be held no less frequently than monthly. The board of directors must also develop a program to monitor Talbot Bank's compliance with the Order. Talbot Bank has completed a plan to increase the participation of its board of directors which includes increasing the frequency of board meetings from monthly to biweekly and establishing a risk management committee of the board which is responsible for monitoring Talbot Bank's compliance with the Order.

**Loss Charge-Offs.** The Order requires that Talbot Bank eliminate from its books, by charge-off or collection, all assets or portions of assets classified "Loss" by the FDIC or the Commissioner. Talbot Bank has eliminated from its books all such classified assets.

**Classified Assets Reduction.** Within 60 days of the effective date of the Order, Talbot Bank was required to submit a Classified Asset Plan to the FDIC and the Commissioner to reduce the risk position in each asset in excess of \$750,000 which was classified "Substandard" and "Doubtful" by the FDIC or the Commissioner. Talbot Bank revised its existing Classified Asset Plan to address the terms of the Order and submitted the updated plan to the FDIC and the Commissioner in accordance with the Order.

**Allowance for Loan and Lease Losses.** Within 60 days of the effective date of the Order, the board of directors was required to review the adequacy of the allowance for loan and lease losses (the "ALLL"), establish a policy for determining the adequacy of the ALLL and submit such ALLL policy to the FDIC and the Commissioner. Talbot Bank amended its ALLL policy to comply with the terms of the Order and submitted the updated policy to the FDIC and the Commissioner in accordance with the Order.

**Loan Policy.** Within 60 days from the effective date of the Order, Talbot Bank was required to (i) review its loan policies and procedures ("Loan Policy") for adequacy, (ii) make all appropriate revisions to the Loan Policy to address the lending deficiencies identified by the FDIC, and (iii) submit the Loan Policy to the FDIC and the Commissioner. Talbot Bank completed its review of and made the required revisions to the Loan Policy. The updated Loan Policy was submitted to the FDIC and the Commissioner in accordance with the terms of the Order.

**Loan Review Program.** Within 30 days from the effective date of the Order, the Board was required to establish a program of independent loan review that provides for a periodic review of Talbot Bank's loan portfolio and the identification and categorization of problem credits (the "Loan Review Program") and submit the Loan Review Program to the FDIC and the Commissioner. Talbot Bank enhanced its existing Loan Review Program and submitted it to the FDIC and the Commissioner in accordance with the terms of the Order.

**Capital Requirements.** Within 90 days from the effective date of the Order, Talbot Bank was required to meet and maintain the following minimum capital levels, after establishing an appropriate ALLL, (i) a leverage ratio (the ratio of Tier 1 capital to total assets) of at least 8%, and (ii) a total risk-based capital ratio (the ratio of qualifying total capital to risk-weighted assets) of at least 12%. As of September 30, 2014, the leverage ratio and total risk-based capital ratio were 8.69% and 13.85%, respectively, for Talbot Bank, which exceeded the Order's minimum capital requirements.

**Profit and Budget Plan.** Within 60 days from the effective date of the Order and within 30 days of each calendar year-end thereafter, Talbot Bank was and will be required to submit a profit and budget plan to the FDIC and the Commissioner consisting of goals and strategies, consistent with sound banking practices, and taking into account Talbot Bank's other plans, policies or other actions required by the Order. In accordance with the Order, Talbot Bank developed a profit and budget plan which was submitted to the FDIC and the Commissioner within 60 days from the effective date of the Order and one which was submitted within 30 days of the end of 2013. The profit and budget plan was approved by the FDIC, additionally the FDIC approved the Talbot Bank capital plan.

**Dividend Restriction.** While the Order is in effect, Talbot Bank cannot declare or pay dividends or fees to the Company without the prior written consent of the FDIC and the Commissioner. Talbot Bank is in compliance with this provision of the Order.

**Brokered Deposits.** The Order provides that Talbot Bank may not accept, renew, or rollover any brokered deposits unless it is in compliance with the requirements of the FDIC regulations governing brokered deposits. Talbot Bank is in compliance with this provision of the Order.

**Oversight Committee.** Within 30 days from the effective date of the Order, Talbot Bank was required to establish a board committee to monitor and coordinate compliance with the Order. Talbot Bank has established a board committee to comply with this provision of the Order.

**Progress Reports.** Within 45 days from the end of each calendar quarter following the effective date of the Order, Talbot Bank must furnish the FDIC and the Commissioner with progress reports detailing the form, manner and results of any actions taken to secure compliance with the Order. Talbot Bank has and will continue to submit progress reports to comply with this provision of the Order.

The Order will remain in effect until modified or terminated by the FDIC and the Commissioner.

### **Critical Accounting Policies**

Our financial statements are prepared in accordance with GAAP. The financial information contained within the financial statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for credit losses, goodwill and other intangible assets, deferred tax assets, and fair value are critical accounting policies. These policies are considered critical because they relate to accounting areas that require the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

#### Allowance for Credit Losses

The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) Topic 450, “Contingencies”, of the Financial Accounting Standards Board’s Accounting Standards Codification (“ASC”), which requires that losses be accrued when they are probable of occurring and estimable; and (ii) ASC Topic 310, “Receivables”, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors to estimate the inherent loss that may be present in our loan portfolio, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes. Actual losses could differ significantly from management’s

estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

Three basic components comprise our allowance for credit losses: (i) the specific allowance; (ii) the formula allowance; and (iii) the unallocated allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is established against impaired loans (i.e., nonaccrual loans and TDRs) based on our assessment of the losses that may be associated with the individual loans. The specific allowance remains until charge-offs are made. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management's estimate of the risk, complexity and size of individual loans within a particular category. Loans identified as special mention, substandard, and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower. The unallocated allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, the estimation of a borrower's prospects of repayment, and the establishment of the allowance factors in the formula allowance and unallocated allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on management's ongoing assessment of the totality of all factors, including, but not limited to, delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements, and their impact on the portfolio. Allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based on the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in management's perception and assessment of these factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs.

### Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are required to be recorded at fair value. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. The Company's reporting units were identified based on an analysis of each of its individual operating segments (i.e., the Banks and Insurance Subsidiaries). If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

Goodwill and other intangible assets at September 30, 2014 decreased \$2.7 million from the end of 2013 mainly due to the sale of the Company's wholesale insurance subsidiary, TSGIA, on June 6, 2014.

### Deferred Tax Assets

Deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences. A valuation allowance, if needed, reduces deferred tax assets to the amount most likely to be realized, which is based on estimates of future taxable income, recoverable taxes paid in prior years and expected results of tax planning strategies.

The Company's deferred tax assets primarily consist of net operating loss carryovers that will be used to offset taxable income in future periods through their statutory period of 20 years for federal tax purposes. No valuation allowance on these deferred tax assets were recorded at September 30, 2014 and December 31, 2013 as management believes it is more likely than not that all deferred tax assets will be realized based on the following positive material assumptions: 1) The company was profitable for three of the four quarters in 2013 on a GAAP basis. The loss experienced in the third quarter of 2013 was solely attributable to the Asset Sale which is considered non-recurring. 2) The Company had pre-tax income of \$6.2 million for the nine months ended September 30, 2014, providing further evidence that the Asset Sale was producing positive results and confirming the expectation of utilizing the deferred tax assets. 3) As a contingent opportunity, the Company has had discussions with certain investors about entering into a sales leaseback transaction for some of its branch locations which would generate a material taxable gain. The decision to act on this has been deferred; however, it would become a very viable option as a tax planning strategy if there was a risk that the net operating loss would expire before they were fully utilized. Alternatively, the Company has reviewed negative factors which would influence the conclusion of realizing the deferred tax assets which include the following: A recovering local economy which has shown signs of improvement over the last two years evidenced by improving

trends in real estate values. The potential inability by the Company to execute its Strategic Plan, which has not been evidenced prior to filing the 2013 consolidated financial statements with the Commission.

Based on the aforementioned considerations, the preponderance of positive factors, mitigation of negative factors, and no intentions of planned material non-routine transactions, the Company concluded that the predominance of observable positive evidence outweighs the future potential of negative evidence and therefore it is more likely than not that the Company will be able to realize in the future all of the net deferred income taxes.

#### Fair Value

The Company measures certain financial assets and liabilities at fair value. Investment securities are significant financial assets measured at fair value on a recurring basis. Impaired loans and other real estate owned are significant financial assets measured at fair value on a nonrecurring basis. Fair value is defined as 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 is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity.

## OVERVIEW

The Company reported net income of \$1.3 million for the third quarter of 2014, or diluted income per common share of \$0.10, compared to net loss of \$11.4 million, or diluted loss per common share of \$(1.35), for the third quarter of 2013. For the second quarter of 2014, the Company reported net income of \$1.305 million, or diluted income per common share of \$0.13. When comparing the third quarter of 2014 to the third quarter of 2013, the primary reason for the improved results were a \$21.7 million decline in the provision for credit losses. When comparing the third quarter of 2014 to the second quarter of 2014, the primary reasons net income decreased was due to a onetime severance charge resulting in an increase in salaries and wage expense in the third quarter of \$397 thousand, which was mainly offset by an increase in net interest income of \$189 thousand and a decrease in credit loss provision of \$175 thousand.

For the first nine months of 2014, the Company reported net income of \$3.8 million, or diluted income per common share of \$0.37, compared to a net loss of \$10.8 million, or diluted loss per common share of \$(1.28), for the first nine months of 2013. Earnings improved due to a decline in the provision for credit losses of \$24.6 million partially offset by a decrease in net interest income of \$900 thousand.

Much of the improvement in the third quarter of 2014 when compared to the third quarter of 2013, and the first nine months of 2014 when compared to the first nine months of 2013 was due to lower credit-related expenses as a result of the execution of an agreement to sell loans and other real estate owned (the "Asset Sale") by one of the Company's banking subsidiaries, The Talbot Bank of Easton, which was recorded in the third quarter of 2013 and completed during the fourth quarter of 2013. Per the agreement, assets included in the Asset Sale had an aggregate book value of \$45.0 million, which consisted of nonaccrual loans (\$11.1 million), accruing TDRs (\$30.4 million), adversely classified performing loans (\$1.8 million) and other real estate owned (\$1.7 million). Subsequently, \$3.5 million in loans included in the agreement were not sold. These loans were reclassified from loans held for sale at December 31, 2013 to loans at March 31, 2014. With the Asset Sale, the Company has refocused its efforts on healthy loan originations and overall business development, however, the slowly improving local economy is delaying any substantial progress.

## RESULTS OF OPERATIONS

### Net Interest Income

Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income was \$8.6 million for the third quarter of 2014 and \$8.8 million for the third quarter of 2013. Tax-equivalent net interest income was \$8.4 million for the second quarter of 2014. The decrease in net interest income for the third quarter of 2014 when compared to the third quarter of 2013 was primarily due to lower volumes of and yields earned on loans, partially offset by lower volumes of and rates paid on time deposits, and money market and savings deposits. The increase in net interest



income for the third quarter of 2014 when compared to the second quarter of 2014 was primarily due to higher volumes of and yields earned on average investment securities and lower volumes of and rates paid on average time deposits. Net interest margin is tax-equivalent net interest income (annualized) divided by average earning assets. Our net interest margin was 3.38% for the third quarter of 2014, compared to 3.54% for the third quarter of 2013 and 3.49% for the second quarter of 2014. The lower net interest margin for the third quarter of 2014 when compared to the third quarter of 2013 and the second quarter of 2014 was mainly due to lower volumes of and yields earned on loans, partially offset by higher volumes of and rates paid on investment securities.

On a tax-equivalent basis, interest income declined \$496 thousand, or 4.9%, for the third quarter of 2014 when compared to the third quarter of 2013. The decrease in interest income was primarily due to a 8.6% decline in average loan balances as the result of the Asset Sale and loan charge-offs occurring in the third quarter of 2013 coupled with the yield earned on loans declining from 5.03% to 4.95%. The decrease in interest income from loans was partially offset by an increase in interest on taxable securities of \$493 thousand, or 138%, and the yield earned on these securities increasing from 1.15% to 1.53%. Although the average balances of the remaining components of average earning assets (i.e., tax-exempt securities, federal funds sold and interest bearing deposits with other banks) decreased \$8.5 million, the yields earned declined 10 basis points, which in aggregate decreased interest income \$10 thousand. Tax-equivalent interest income increased \$163 thousand, or 1.7%, when compared to the second quarter of 2014 mainly due to higher volumes of and yields earned on average investment securities, which were partially offset by lower yields on loans.

Interest expense decreased \$304 thousand, or 22.5%, when comparing the third quarter of 2014 to the third quarter of 2013. The decrease in interest expense was due to a 14 basis point decline in rates paid on interest-bearing liabilities (i.e., deposits and borrowings) and a 2.3% decline in average balances of interest-bearing liabilities. Changes in the rates and balances related to time deposits (i.e., certificates of deposit \$100,000 or more and other time deposits) had the largest impact on interest expense. For the three months ended September 30, 2014, the rates paid on time deposits decreased 19 basis points and the average balances of these deposits decreased \$45 million, or 11.5%, when compared to the same period last year, which reduced interest expense \$306 thousand. The decrease in average time deposits reflected a reduction in the Company's liquidity needs and the lower rates reflected current market conditions. Additionally, the rates paid on demand deposits decreased 2 basis points and the average balances of these deposits increased \$10.9 million, or 6.4%, which reduced interest expense \$3 thousand. When comparing the third quarter of 2014 to the second quarter of 2014, interest expense decreased \$26 thousand, or 2.4%. The decline was primarily due to lower interest rates paid on and average balances of time deposits.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended September 30, 2014 and 2013.

(Dollars in thousands)	For the Three Months Ended September 30, 2014			For the Three Months Ended September 30, 2013		
	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
<b>Earning assets</b>						
Loans (2), (3)	\$ 705,637	\$ 8,809	4.95 %	\$ 772,008	\$ 9,789	5.03 %
<b>Investment securities:</b>						
Taxable	221,105	850	1.53	123,499	357	1.15
Tax-exempt	432	5	4.16	521	7	5.27
Federal funds sold	1,378	1	0.06	1,618	-	0.07
Interest-bearing deposits	87,215	44	0.20	95,422	53	0.22
<b>Total earning assets</b>	<b>1,015,767</b>	<b>9,709</b>	<b>3.79 %</b>	<b>993,068</b>	<b>10,206</b>	<b>4.08 %</b>
Cash and due from banks	24,445			22,088		
Other assets	61,989			65,001		
Allowance for credit losses	(9,098 )			(15,238 )		
<b>Total assets</b>	<b>\$ 1,093,103</b>			<b>\$ 1,064,919</b>		
<b>Interest-bearing liabilities</b>						
Demand deposits	\$ 183,094	65	0.14 %	\$ 172,143	68	0.16 %
Money market and savings deposits	225,670	69	0.12	207,162	62	0.12
Certificates of deposit \$100,000 or more	166,806	467	1.11	198,495	614	1.23
Other time deposits	179,533	445	0.98	192,878	604	1.24
Interest-bearing deposits	755,103	1,046	0.55	770,678	1,348	0.69
Short-term borrowings	7,946	4	0.21	10,695	6	0.23
<b>Total interest-bearing liabilities</b>	<b>763,049</b>	<b>1,050</b>	<b>0.55 %</b>	<b>781,373</b>	<b>1,354</b>	<b>0.69 %</b>
Noninterest-bearing deposits	185,209			162,189		

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Other liabilities	6,230	7,453
Stockholders' equity	138,615	113,904
Total liabilities and stockholders' equity	\$ 1,093,103	\$ 1,064,919

Net interest spread	\$ 8,659	3.24 %	\$ 8,852	3.39 %
Net interest margin		3.38 %		3.54 %

Tax-equivalent adjustment

Loans	\$ 22	\$ 22
Investment securities	2	2
Total	\$ 24	\$ 24

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0%, exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

Tax-equivalent net interest income for the nine months ended September 30, 2014 was \$25.5 million, as seen in the table below. This represented a decrease of \$909 thousand, or 3.4%, when compared to the same period last year. The decrease was mainly due to lower volumes of and yields earned on average loans, partially offset by lower volumes of and rates paid on time deposits and money market and savings deposits. This resulted in a decrease in the net interest margin to 3.46% for the first nine months of 2014 from the 3.48% for the first nine months of 2013.

On a tax-equivalent basis, interest income was \$28.7 million for the first nine months of 2014, a decrease of \$2.9 million, or 9.1%, when compared to the first nine months of 2013, mainly due to the impact of loan activity. For the first nine months of 2014, average loans declined 9.4% and the related yield declined 10 basis points when compared to the same period in 2013.

Interest expense was \$3.3 million for the nine months ended September 30, 2014, a decrease of \$2.0 million, or 37.8%, when compared to the same period last year. Average interest-bearing liabilities decreased \$45.9 million, or 5.7%, while rates paid declined 30 basis points to 0.57% primarily due to time deposit, and money market and savings deposit activity. For the first nine months of 2014, the average balance of time deposits decreased \$47.6 million, or 11.8%, when compared to the same period last year, and the average rate paid on these deposits declined 26 basis points, which reduced interest expense \$1.1 million. For the nine months ended September 30, 2014, the average balance of money market and savings deposits decreased \$2.4 million, or 1.1%, when compared to the same period last year, and the average rate paid on these deposits declined 49 basis points, which reduced interest expense \$819 thousand. The decrease in average time deposits reflected a reduction in the Company's liquidity needs while the lower rates reflected current market conditions, the decrease in money market and savings deposits and interest expense was due to terminating interest rate caps associated with the deposits from the Promontory Insured Network Deposits Program ("IND Program"), which was fully exited in June 2013.

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The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the nine months ended September 30, 2014 and 2013.

(Dollars in thousands)	For the Nine Months Ended September 30, 2014			For the Nine Months Ended September 30, 2013		
	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
<b>Earning assets</b>						
Loans (2), (3)	\$ 707,347	\$ 26,539	5.02 %	\$ 780,359	\$ 29,887	5.12 %
<b>Investment securities:</b>						
Taxable	186,694	2,040	1.46	136,680	1,568	1.53
Tax-exempt	432	14	4.21	560	21	4.97
Federal funds sold	1,519	1	0.05	4,241	3	0.10
Interest-bearing deposits	88,405	139	0.21	92,403	143	0.21
<b>Total earning assets</b>	<b>984,397</b>	<b>28,733</b>	<b>3.90 %</b>	<b>1,014,243</b>	<b>31,622</b>	<b>4.17 %</b>
Cash and due from banks	22,516			23,177		
Other assets	65,154			67,036		
Allowance for credit losses	(9,801 )			(16,306 )		
<b>Total assets</b>	<b>\$ 1,062,266</b>			<b>\$ 1,088,150</b>		
<b>Interest-bearing liabilities</b>						
Demand deposits	\$ 176,000	187	0.14 %	\$ 169,476	200	0.16 %
Money market and savings deposits (4)	222,979	202	0.12	225,351	1,021	0.61
Certificates of deposit \$100,000 or more	172,422	1,444	1.12	206,076	2,024	1.31
Other time deposits	183,259	1,411	1.03	197,201	1,973	1.34
Interest-bearing deposits	754,660	3,244	0.57	798,104	5,218	0.87
Short-term borrowings	8,636	14	0.22	11,140	20	0.25
<b>Total interest-bearing liabilities</b>	<b>763,296</b>	<b>3,258</b>	<b>0.57 %</b>	<b>809,244</b>	<b>5,238</b>	<b>0.87 %</b>
Noninterest-bearing deposits	171,761			156,286		
Other liabilities	7,029			8,500		
Stockholders' equity	120,180			114,120		
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,062,266</b>			<b>\$ 1,088,150</b>		
<b>Net interest spread</b>		<b>\$ 25,475</b>	<b>3.33 %</b>		<b>\$ 26,384</b>	<b>3.30 %</b>
<b>Net interest margin</b>			<b>3.46 %</b>			<b>3.48 %</b>
<b>Tax-equivalent adjustment</b>						
Loans		\$ 65			\$ 71	
Investment securities		5			7	
<b>Total</b>		<b>\$ 70</b>			<b>\$ 78</b>	

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0%, exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

Interest on money market and savings deposits for the nine months ended September 30, 2013 included an adjustment to expense related to interest rate caps and the hedged deposits from the IND Program associated with

(4) them. This adjustment increased interest expense \$819 thousand for the nine months ended September 30, 2013. Interest expense for the nine months ended September 30, 2014 did not reflect this adjustment because the interest rate caps were terminated in June of 2013.

### **Noninterest Income**

Total noninterest income for the third quarter of 2014 decreased \$798 thousand, or 16.7%, when compared to the third quarter of 2013. Included in total noninterest income for the third quarter of 2013 was a \$297 thousand nonrecurring adjustment from an insurance investment and a loss of commission income of \$756 thousand due to the sale of Tri-State General Insurance Agency, LTD ("TSGIA"), the Company's wholesale insurance subsidiary, in June of 2014. These losses were partially offset by increases in retail commissions of \$208 thousand. When compared to the second quarter of 2014, noninterest income declined \$534 thousand, or 11.8%, for the third quarter of 2014. The decrease from the second quarter of 2014 was primarily due to the TSGIA sale which resulted in a decline in insurance agency commissions of \$728 thousand and a gain on sale of \$114 thousand, partially offset by an increase in retail commissions of \$370 thousand.

Total noninterest income for the nine months ended September 30, 2014 increased \$66 thousand, or 0.5%, when compared to the same period in 2013. Included in total noninterest income for the first nine months of 2013 were the \$1.3 million loss incurred to terminate interest rate caps and the \$913 thousand in gains on sales of investment securities. In addition, the losses on insurance agency commissions and investment fee income as the result of the TSGIA sale mentioned above, were partially offset by the gain on the sale of TSGIA of \$114 thousand and an increase in trust and investment fee income of \$198 thousand resulting in a slight increase in total noninterest income for the first nine months of 2014 when compared to the first nine months of 2013.

### **Noninterest Expense**

Total noninterest expense for the third quarter of 2014 decreased \$149 thousand, or 1.5%, when compared to the third quarter of 2013 and declined \$98 thousand, or 1.0%, when compared to the second quarter of 2014. The primary reason for the decrease in total noninterest expense from the third quarter of 2013 was the decline in insurance agency commission expenses of \$409 thousand resulting from the TSGIA sale noted above, which was partially offset by an increase in salary and wages of \$269 thousand due to a one-time cost of severance and related benefits for the former Chief Executive Officer of CNB, one of the Company's two banking subsidiaries, in September of 2014. The decrease from the second quarter of 2014 was primarily due to a decline in operating expenses of \$836 thousand which was attributed to the TSGIA sale. This decline was somewhat offset by the increase in salary and wages expense of \$397 thousand noted above for the one-time severance cost and \$189 thousand in write-downs of other real estate owned.

Total noninterest expense for the nine months ended September 30, 2014 declined \$367 thousand, or 1.2%, when compared to the same period in 2013. The decreases were primarily due to lower write-downs of other real estate owned of \$481 thousand, or 50.8%, and the decrease in insurance agency commission expenses of \$422 thousand, or 31.8% due to the sale of TSGIA, which was partially offset by higher expenses in salaries and wages of \$285 thousand, or 2.2% relating to the one-time severance cost noted above.

### **Income Taxes**

For the third quarter of 2014 and 2013, the Company reported income tax expense of \$774 thousand and a tax benefit of \$7.4 million, respectively, while the effective tax rate was 38% and 39.4%, respectively. For the first nine months of 2014 and 2013, the Company reported income tax expense of \$2.3 million and income tax benefit of \$7.2 million, respectively, while the effective tax rate was 38% and 39.9%, respectively. The lower tax rates for the third quarter and first nine months of 2014 when compared to the same periods in 2013 were due to the impact of the tax benefits of the Company's affiliates with pretax losses which partially offset the tax expense of the affiliates with pretax income.

The Company has net operating loss carryforwards ("NOLs") for federal and state income tax purposes that can be utilized to offset future taxable income. The Company's use of the NOLs would be limited, however, under Section 382 of the Internal Revenue Code ("IRC"), if the Company were to undergo a change in ownership of more than 50% of its capital stock over a three-year period as measured under Section 382 of the IRC. These complex changes of

ownership rules generally focus on ownership changes involving shareholders owning directly or indirectly 5% or more of the Company's stock, including certain public "groups" of shareholders as set forth under Section 382 of the IRC, including those arising from new stock issuances and other equity transactions. Due to the stock sale in June, 2014 and other ownership changes by shareholders owning 5% or more of the Company's stock, the Company estimates that it has experienced an ownership change of approximately 40% for the three-year period ended September 30, 2014. The Company intends to take all action within its control to prevent a change in ownership in excess of 50% over any three-year testing period. For a further discussion of Section 382 and the potential impact on the Company, see "Part II - Item 1A. Risk Factors" herein.

## ANALYSIS OF FINANCIAL CONDITION

### Loans

Loans, including loans held for sale, totaled \$705 million at September 30, 2014 and \$715.4 million at December 31, 2013, a decline of \$10.4 million, or 1.5%. At December 31, 2013, \$3.5 million of nonaccrual construction loans were classified as held for sale and were reclassified to loans during the first quarter of 2014. Commercial real estate loans reflected the largest decline (\$6.8 million) from the end of 2013 primarily due to net loan repayments and charge-offs. Overall loan growth has been impacted by the lack of high quality loan opportunities in the local economy. The decline in commercial real estate loans were partially offset by increases in residential real estate loans of \$1.6 million and construction loans of \$2.8 million. Loans included deferred costs, net of deferred fees, of \$355 thousand at September 30, 2014 and \$341 thousand at December 31, 2013. We do not engage in foreign or subprime lending activities. See Note 4, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements and below under the caption "Allowance for Credit Losses" for additional information.



Our loan portfolio has a commercial real estate loan concentration, which is defined as a combination of construction and commercial real estate loans. Construction loans were \$67.3 million, or 9.6% of total loans, at September 30, 2014, similar to the \$68.1 million, or 9.5% of total loans, including loans held for sale, at December 31, 2013. Commercial real estate loans were \$297.8 million, or 42.2% of total loans, at September 30, 2014, compared to \$304.6 million, or 42.6% of total loans, including loans held for sale, at December 31, 2013.

### **Allowance for Credit Losses**

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The evaluation of the adequacy of the allowance for credit losses is based primarily on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans, each grouped by loan type. Each loan type is assigned allowance factors based on criteria such as past credit loss experience, local economic and industry trends, and other measures which may impact collectibility. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology management employs to maintain the allowance.

The provision for credit losses was \$775 thousand for the third quarter of 2014, \$22.5 million for the third quarter of 2013 and \$950 thousand for the second quarter of 2014. The lower level of provision for credit losses when comparing the third quarter of 2014 to the third quarter of 2013 was primarily due to decreases in loan charge-offs and nonaccrual loans. The lower level of provision for credit losses when comparing the third quarter of 2014 to the second quarter of 2014 was primarily due to declines in nonaccrual loans. The provision for credit losses for the first nine months of 2014 declined to \$2.7 million from \$27.3 million for the first nine months of 2013.

Net charge-offs were \$1.2 million for the third quarter of 2014 and \$26.9 million for the third quarter of 2013, as shown in the following table. Net charge-offs were \$1.9 million for the second quarter of 2014. Net charge-offs were \$4.8 million and \$32 million for the first nine months of 2014 and 2013, respectively. Management remains focused on its efforts to dispose of problem loans and to charge off nonperforming assets as rapidly as possible, to enable the Company to continue to improve its overall credit quality and reduce problem loans. The allowance for credit losses as a percentage of period-end loans was 1.22% for the third quarter of 2014, lower than the 1.57% for the third quarter of 2013 and 1.28% for the second quarter of 2014, which reflects improved credit quality in the loan portfolio. Management believes that the provision for credit losses and the resulting allowance were adequate to provide for probable losses inherent in our loan portfolio at September 30, 2014.

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The following table presents a summary of the activity in the allowance for credit losses for the three and nine months ended September 30, 2014 and 2013.

(Dollars in thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Allowance balance – beginning of period	\$ 9,076	\$ 15,723	\$ 10,725	\$ 15,991
Charge-offs:				
Construction	(213 )	(18,539 )	(454 )	(20,048 )
Residential real estate	(242 )	(4,225 )	(1,229 )	(6,114 )
Commercial real estate	(35 )	(4,056 )	(1,648 )	(6,003 )
Commercial	(1,019 )	(196 )	(1,956 )	(419 )
Consumer	(6 )	(3 )	(153 )	(65 )
Totals	(1,515 )	(27,019 )	(5,440 )	(32,649 )
Recoveries:				
Construction	1	3	12	5
Residential real estate	229	51	335	349
Commercial real estate	9	20	22	113
Commercial	24	47	231	149
Consumer	7	16	21	33
Totals	270	137	621	649
Net charge-offs	(1,245 )	(26,882 )	(4,819 )	(32,000 )
Provision for credit losses	775	22,460	2,700	27,310
Allowance balance – end of period	\$ 8,606	\$ 11,301	\$ 8,606	\$ 11,301
Average loans outstanding during the period	\$ 705,637	\$ 772,008	\$ 707,347	\$ 780,359
Net charge-offs (annualized) as a percentage of average loans outstanding during the period	0.70 %	13.81 %	0.91 %	5.48 %
Allowance for credit losses at period end as a percentage of average loans	1.22 %	1.46 %	1.22 %	1.45 %

### Nonperforming Assets and Accruing TDRs

As shown in the following table, nonperforming assets decreased to \$17.5 million at September 30, 2014 from \$22.2 million at December 31, 2013, primarily due to a \$5.4 million decline in nonaccrual loans, including nonaccrual loans held for sale. In addition, accruing TDRs declined \$842 thousand to \$25.2 million at September 30, 2014 from \$26.1 million at December 31, 2013. The ratio of nonaccrual loans to total assets improved to 1.16% at September 30, 2014 from 1.72% at December 31, 2013. In addition, the ratio of accruing TDRs to total assets improved to 2.30% at September 30, 2014 from 2.47% at December 31, 2013.

The Company continues to focus on the resolution of its nonperforming and problem loans. The efforts to accomplish this goal include frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon; obtaining updated appraisals; provisioning for credit losses; charging off loans; transferring loans to other real estate owned; aggressively marketing other real estate owned; and selling loans. The reduction of

nonperforming and problem loans is and will continue to be a high priority for the Company.

The following table summarizes our nonperforming assets and accruing TDRs at September 30, 2014 and December 31, 2013.

(Dollars in thousands)	September 30, 2014	December 31, 2013		
Nonperforming assets				
Nonaccrual loans excluding nonaccrual loans held for sale				
Construction	\$ 7,001	\$ 3,949		
Residential real estate	2,373	5,166		
Commercial real estate	2,756	4,671		
Commercial	465	792		
Consumer	123	48		
Total nonaccrual loans excluding nonaccrual loans held for sale	12,718	14,626		
Loans 90 days or more past due and still accruing				
Construction	-	-		
Residential real estate	-	20		
Commercial real estate	-	-		
Commercial	-	250		
Consumer	-	-		
Total loans 90 days or more past due and still accruing	-	270		
Other real estate owned	4,799	3,779		
Total nonperforming assets excluding nonaccrual loans held for sale	17,517	18,675		
Nonaccrual loans held for sale	-	3,521		
Total nonperforming assets including nonaccrual loans held for sale	\$ 17,517	\$ 22,196		
Accruing TDRs				
Construction	\$ 3,403	\$ 1,620		
Residential real estate	16,225	14,582		
Commercial real estate	5,566	9,791		
Commercial	52	95		
Consumer	-	-		
Total accruing TDRs	\$ 25,246	\$ 26,088		
Total nonperforming assets and accruing TDRs excluding nonaccrual loans held for sale	\$ 42,763	\$ 44,763		
Nonaccrual loans held for sale	-	3,521		
Total nonperforming assets and accruing TDRs including nonaccrual loans held for sale	\$ 42,763	\$ 48,284		
As a percent of total loans (1):				
Nonaccrual loans	1.80	%	2.54	%
Accruing TDRs	3.58	%	3.65	%
Nonaccrual loans and accruing TDRs	5.38	%	6.19	%

As a percent of total loans and other real estate owned (1):

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Nonperforming assets	2.47	%	3.09	%
Nonperforming assets and accruing TDRs	6.02	%	6.72	%
As a percent of total assets:				
Nonaccrual loans	1.16	%	1.72	%
Nonperforming assets	1.60	%	2.11	%
Accruing TDRs	2.30	%	2.47	%
Nonperforming assets and accruing TDRs	3.90	%	4.58	%

(1) The calculations for December 31, 2013 include loans held for sale that were reclassified to loans during the first quarter of 2014.

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## **Investment Securities**

The investment portfolio is comprised of securities that are either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent securities which may be sold as part of the asset/liability management strategy or in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At September 30, 2014, 98% of the portfolio was classified as available for sale and 2% as held to maturity, similar to the 97% and 3%, respectively, at December 31, 2013. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale. See Note 3, "Investment Securities", in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities totaled \$228.0 million at September 30, 2014, a \$75.7 million, or 43%, increase since December 31, 2013. The increase was mainly in mortgage-backed securities due to purchases that were partly funded by the proceeds from the stock sale. At the end of September 2014, 69.5% of the securities available for sale were mortgage-backed, 27.9% were U.S. Government agencies and 2.4% were U.S. Treasuries, compared to 54.9%, 41.1% and 3.6%, respectively, at year-end 2013. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

## **Deposits**

Total deposits at September 30, 2014 were \$940.7 million, a \$7.2 million, or 0.8%, increase when compared to the level at December 31, 2013. The increase in total deposits was mainly due to an increase in noninterest-bearing demand deposits of \$17.4 million and money market and savings deposits of \$13.7 million, which were partially offset by a decline in time deposits of \$29.8 million.

## **Short-Term Borrowings**

Short-term borrowings at September 30, 2014 and December 31, 2013 were \$10.8 million and \$10.1 million, respectively. Short-term borrowings generally consist of securities sold under agreements to repurchase, which are issued in conjunction with cash management services for commercial depositors, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank (the "FHLB"). Short-term advances are defined as those with original maturities of one year or less. At September 30, 2014 and December 31, 2013, short-term borrowings included only repurchase agreements.

## **Liquidity and Capital Resources**

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. As seen in the Consolidated Statements of Cash Flows in the Financial Statements, the net decrease in cash was \$21.5 million for the first nine months of 2014 compared to a net decrease in cash of \$93.3 million for the first nine months of 2013. The decline in cash in 2014 was mainly due to the purchase of investment securities that were partly funded by the proceeds from the stock sale. The decline in cash in 2013 was primarily due to a reduction in money market deposit accounts as a result of fully exiting the IND Program in June 2013.

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. The Banks had \$15.5 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at both September 30, 2014 and December 31, 2013. The Banks are also members of the FHLB, which provides another source of liquidity. Through the FHLB, the Banks had credit availability of approximately \$83 million and \$46.9 million at September 30, 2014 and December 31, 2013, respectively. These lines of credit are paid for monthly on a fee basis of 0.09%. CNB has pledged, under a blanket lien, all qualifying residential loans under borrowing agreements with the FHLB, whereas Talbot Bank is required to provide specific loans and cash or investment securities as collateral due to its current credit rating with the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity increased \$35.4 million to \$138.7 million at September 30, 2014 when compared to December 31, 2013 primarily due to the proceeds from the stock sale and current year's earnings. Due to the success of the stock sale, total stockholders' equity to total assets increased to 12.65% at September 30, 2014 from 9.80% at December 31, 2013, providing additional capital strength to the Company and its subsidiaries.

Bank regulatory agencies have adopted various capital standards for financial institutions, including risk-based capital standards. The primary objectives of the risk-based capital framework are to provide a more consistent system for comparing capital positions of financial institutions and to take into account the different risks among financial institutions' assets and off-balance sheet items. Risk-based capital standards have been supplemented with requirements for a minimum Tier 1 capital to average assets ratio (leverage ratio). The minimum ratios for capital adequacy purposes are 4.00%, 4.00% and 8.00% for the Tier 1 leverage, Tier 1 risk-based capital and total risk-based capital ratios, respectively. To be categorized as well capitalized, a bank must maintain minimum ratios of 5.00%, 6.00% and 10.00% for its Tier 1 leverage, Tier 1 risk-based capital and total risk-based capital ratios, respectively. The Company contributed \$20.0 million of the net proceeds of the stock sale to Talbot Bank to satisfy regulatory capital requirements.

The following tables present the capital ratios for Shore Bancshares, Inc., Talbot Bank and CNB as of September 30, 2014 and December 31, 2013.

	Tier 1 leverage ratio		Tier 1 risk-based capital ratio		Total risk-based capital ratio	
September 30, 2014						
Company	10.38	%	15.09	%	16.32	%
Talbot Bank	8.69	%	12.60	%	13.85	%
CNB	9.16	%	13.59	%	14.84	%

	Tier 1 leverage ratio		Tier 1 risk-based capital ratio		Total risk-based capital ratio	
December 31, 2013						
Company	7.03	%	10.09	%	11.34	%
Talbot Bank	4.98	%	6.92	%	8.17	%
CNB	9.16	%	13.82	%	15.07	%

### Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2013 under the caption "Market Risk Management and Interest Sensitivity". Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2013.

### Item 4. Controls and Procedures.



We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that Shore Bancshares, Inc. files under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to management, including Shore Bancshares, Inc.'s principal executive officer ("CEO") and its principal accounting officer ("PAO"), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of September 30, 2014 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, the Company's management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level at September 30, 2014.

There was no change in our internal control over financial reporting during the second quarter of 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

### Item 1. Legal Proceedings

From time to time the Company may become involved in legal proceedings. At the present time, there are no proceedings which the Company believes will have a material adverse impact on the financial condition or earnings of the Company.

### Item 1A. Risk Factors

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2013. Other than as set forth below, Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

***The change of control rules under Section 382 of the Internal Revenue Code may limit the Company's ability to use its net operating loss carryforwards ("NOLs") and other tax attributes to reduce future tax payments which may have an adverse impact on the Company's results of operations.***

The Company has NOLs for federal and state income tax purposes that can be utilized to offset future taxable income. The Company's use of the NOLs would be limited, however, under Section 382 of the IRC, if the Company were to undergo a change in ownership of more than 50% of our capital stock over a three-year period as measured under Section 382 of the IRC. The annual limit generally would equal the product of the applicable federal long term tax exempt rate and the value of the Company's capital stock immediately before the ownership change. Due to the stock sale in June, 2014 and other ownership changes by shareholders owning 5% or more of the Company's stock, the Company estimates that it has experienced an ownership change of approximately 40% for the three-year period ended September 30, 2014.

If the Company experiences an ownership change, the resulting annual limit on the use of its NOLs could result in a meaningful increase in our federal and state income tax liability in future years. Whether an ownership change occurs by reason of public trading in the Company's stock is largely outside its control, and the determination of whether an ownership change has occurred is complex. No assurance can be given that the Company will not in the future undergo an ownership change that would have an adverse effect on its results of operations and the value of its stock.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not Applicable

**Item 5. Other Information**

None

**Item 6. Exhibits.**

The exhibits filed or furnished with this quarterly report are shown on the Exhibit List that follows the signatures to this report, which list is incorporated herein by reference.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**SHORE BANCSHARES, INC.**

Date: November 12, 2014 By: /s/ Lloyd L. Beatty, Jr.  
Lloyd L. Beatty, Jr.  
President & Chief Executive Officer  
(Principal Executive Officer)

Date: November 12, 2014 By: /s/ George S. Rapp  
George S. Rapp  
Vice President & Chief Financial Officer  
(Principal Financial Officer)

**EXHIBIT INDEX**

Exhibit Number	Description
31.1	Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
31.2	Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).
101	Interactive Data File
42	