SHORE BANCSHARES INC
Form 10-Q
August 09, 2011

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

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2011

OR

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

For the transition period from ________ to ________

Commission file number 0-22345

SHORE BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	52-1974638 (I.R.S. Employer Identification No.)
18 East Dover Street, 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 þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 þ No ¨

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 8,457,359 shares of common stock outstanding as of July 29, 2011.

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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)

	June 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
Cash and due from banks	$21,234	$ 19,680
Interest-bearing deposits with other banks	45,598	21,593
Federal funds sold	13,881	36,691
Investment securities:		
Available for sale, at fair value	106,742	99,055
Held to maturity, at amortized cost – fair value of $6,747 (2011) and $6,851 (2010)	6,529	6,727
Loans	877,331	895,404
Less: allowance for credit losses	(16,358)	(14,227)
Loans, net	860,973	881,177
Premises and equipment, net	14,377	14,483
Goodwill	13,678	13,678
Other intangible assets, net	4,583	4,840
Other real estate and other assets owned, net	7,877	3,702
Other assets	28,719	28,685
TOTAL ASSETS	$1,124,191	$ 1,130,311
LIABILITIES		
Deposits:		
Noninterest-bearing	$130,789	$ 124,188
Interest-bearing	842,653	855,328
Total deposits	973,442	979,516
Short-term borrowings	18,251	16,041
Other liabilities	10,625	11,309
Long-term debt	932	932
TOTAL LIABILITIES	1,003,250	1,007,798
STOCKHOLDERS' EQUITY		
Common stock, par value $.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 8,457,359 (2011) and 8,443,436 (2010)	85	84
Warrant	1,543	1,543
Additional paid in capital	30,334	30,242
Retained earnings	90,551	92,458
Accumulated other comprehensive loss	(1,572)	(1,814)
TOTAL STOCKHOLDERS' EQUITY	120,941	122,513
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,124,191	$ 1,130,311

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 June 30,		For the Six Months Ended June 30,	
	2011	2010	2011	2010
INTEREST INCOME				
Interest and fees on loans	$ 11,896	$ 13,047	$23,897	$25,921
Interest and dividends on investment securities:				
Taxable	782	846	1,439	1,728
Tax-exempt	40	56	78	115
Interest on federal funds sold	5	14	21	26
Interest on deposits with other banks	12	4	18	5
Total interest income	12,735	13,967	25,453	27,795
INTEREST EXPENSE				
Interest on deposits	2,769	3,242	5,602	6,627
Interest on short-term borrowings	13	19	26	51
Interest on long-term debt	11	15	21	31
Total interest expense	2,793	3,276	5,649	6,709
NET INTEREST INCOME	9,942	10,691	19,804	21,086
Provision for credit losses	5,395	4,917	11,785	12,534
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	4,547	5,774	8,019	8,552
NONINTEREST INCOME				
Service charges on deposit accounts	744	831	1,448	1,617
Trust and investment fee income	418	372	794	788
Gains on sales of investment securities	2	-	81	-
Insurance agency commissions	2,475	2,595	4,985	5,484
Other noninterest income	742	770	1,468	1,561
Total noninterest income	4,381	4,568	8,776	9,450
NONINTEREST EXPENSE				
Salaries and wages	4,104	4,363	8,350	8,853
Employee benefits	886	758	2,039	2,039
Occupancy expense	568	597	1,164	1,219
Furniture and equipment expense	291	313	563	613
Data processing	680	660	1,531	1,291
Directors' fees	112	105	219	226
Amortization of other intangible assets	128	129	257	258
Insurance agency commissions expense	357	464	732	892
FDIC insurance premium expense	404	460	864	941
Other noninterest expenses	1,664	1,839	3,366	3,677

Total noninterest expense	9,194	9,688	19,085	20,009
(LOSS) INCOME BEFORE INCOME TAXES	(266)	654	(2,290)	(2,007)
Income tax (benefit) expense	(33)	209	(974)	(890)
NET (LOSS) INCOME	$ (233)	$ 445	$(1,316)	$(1,117)
Basic net (loss) income per common share	$ (0.03)	$ 0.05	$(0.16)	$(0.13)
Diluted net (loss) income per common share	$ (0.03)	$ 0.05	$(0.16)	$(0.13)
Dividends paid per common share	$ 0.01	$ 0.06	$0.07	$0.12

See accompanying notes to Consolidated Financial Statements.

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SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME (Unaudited)
(Dollars in thousands)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2011	2010	2011	2010
Net (loss) income	$ (233)	$ 445	$(1,316)	$(1,117)
Other comprehensive income (loss):				
Securities available for sale:				
Unrealized holding gains on available-for-sale securities	1,204	1,338	832	1,412
Tax effect	(490)	(538)	(340)	(568)
Reclassification of gains recognized in net income	(2)	-	(81)	-
Tax effect	1	-	33	-
Net of tax amount	713	800	444	844
Cash flow hedging activities:				
Unrealized holding losses on cash flow hedging activities	(714)	(2,135)	(337)	(3,466)
Tax effect	288	862	135	1,399
Net of tax amount	(426)	(1,273)	(202)	(2,067)
Total other comprehensive income (loss)	287	(473)	242	(1,223)
Comprehensive (loss) income	$ 54	$ (28)	$(1,074)	$(2,340)

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Six Months Ended June 30, 2011 and 2010
(Dollars in thousands, except per share amounts)

	Common Stock	Warrant	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2011	$ 84	$ 1,543	$ 30,242	$ 92,458	$ (1,814)	$ 122,513
Comprehensive loss:						
Net loss	-	-	-	(1,316)	-	(1,316)
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	-	444	444
Unrealized losses on cash flow hedging activities, net of taxes	-	-	-	-	(202)	(202)
Total comprehensive loss						(1,074)
Shares issued for employee stock-based awards	1	-	(1)	-	-	-
Stock-based compensation	-	-	93	-	-	93
Cash dividends paid ($0.07 per share)	-	-	-	(591)	-	(591)
Balances, June 30, 2011	$ 85	$ 1,543	$ 30,334	$ 90,551	$ (1,572)	$ 120,941
Balances, January 1, 2010	$ 84	$ 1,543	$ 29,872	$ 96,151	$ 160	$ 127,810
Comprehensive loss:						
Net loss	-	-	-	(1,117)	-	(1,117)
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	-	844	844
Unrealized losses on cash flow hedging activities, net of taxes	-	-	-	-	(2,067)	(2,067)
Total comprehensive loss						(2,340)
Stock-based compensation	-	-	209	-	-	209
Cash dividends paid ($0.12 per share)	-	-	-	(1,013)	-	(1,013)
Balances, June 30, 2010	$ 84	$ 1,543	$ 30,081	$ 94,021	$ (1,063)	$ 124,666

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Dollars in thousands)

	For the Six Months Ended June 30, 2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(1,316)	$(1,117)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Provision for credit losses	11,785	12,534
Depreciation and amortization	1,269	1,147
Discount accretion on debt securities	(44)	(63)
Stock-based compensation expense	137	209
Excess tax (expense) benefits from stock-based arrangements	(44)	2
Deferred income taxes	(1,306)	(1,668)
Gains on sales of securities	(81)	-
Gains on disposals of premises and equipment	(3)	-
Losses on sales of other real estate owned	235	577
Net changes in:		
Accrued interest receivable	807	199
Other assets	(88)	945
Accrued interest payable	15	(384)
Other liabilities	(699)	(1,923)
Net cash provided by operating activities	10,667	10,458
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of investment securities available for sale	25,058	26,343
Proceeds from sales of investment securities available for sale	12,073	-
Purchases of investment securities available for sale	(44,418)	(25,797)
Proceeds from maturities and principal payments of investment securities held to maturity	186	585
Net change in loans	3,365	742
Purchases of premises and equipment	(420)	(1,183)
Proceeds from sales of premises and equipment	4	-
Proceeds from sales of other real estate owned	644	784
Investment in unconsolidated subsidiary	-	(25)
Net cash (used in) provided by investing activities	(3,508)	1,449
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net changes in:		
Noninterest-bearing deposits	6,601	(1,082)
Interest-bearing deposits	(12,674)	(18,247)
Short-term borrowings	2,210	(2,540)
Excess tax expense (benefits) from stock-based arrangements	44	(2)
Common stock dividends paid	(591)	(1,013)
Net cash used in financing activities	(4,410)	(22,884)
Net increase (decrease) in cash and cash equivalents	2,749	(10,977)

Cash and cash equivalents at beginning of period	77,964	75,646
Cash and cash equivalents at end of period	$80,713	$64,669
Supplemental cash flows information:		
Interest paid	$5,635	$7,094
Income taxes paid	$1,861	$846
Transfers from loans to other real estate owned	$5,055	$216

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.
Notes to Consolidated Financial Statements
For the Three and Six Months Ended June 30, 2011 and 2010
(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 June 30, 2011, the consolidated results of operations and comprehensive loss for the three and six months ended June 30, 2011 and 2010, and changes in stockholders' equity and cash flows for the six months ended June 30, 2011 and 2010, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2010 were derived from the 2010 audited financial statements. The results of operations for the three and six months ended June 30, 2011 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, 2010. 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 Pronouncements

Accounting Standards Update ("ASU") No. 2010-28, "Intangibles - Goodwill and Other (Topic 350) - When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts." ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist such as if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. ASU 2010-28 became effective for the Company on January 1, 2011 and did not have a significant impact on the Company's financial statements.

ASU No. 2011-02, "Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring." ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (1) the restructuring constitutes a concession; and (2) the debtor is experiencing financial difficulties. ASU 2011-02 will be effective for the Company on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. Adoption of ASU 2011-02 is not expected have a significant impact on the Company's financial statements.

ASU No. 2011-03, "Reconsideration of Effective Control for Repurchase Agreements." ASU No. 2011-03 affects all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The amendments in ASU No. 2011-03 remove from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU No. 2011-03 also eliminates the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. The guidance is effective for the Company's reporting period ended March 31, 2012. The guidance will be applied prospectively to transactions or modifications of existing transactions that occur on or after January 1, 2012.

ASU No. 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." ASU No. 2011-04 results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards ("IFRS"). As a result of ASU No. 2011-04, the following changes were made to U.S. GAAP. First, the concepts of highest and best use and valuation premise are relevant only when measuring the fair value of nonfinancial assets (that is, they do not apply to financial assets or any liabilities). Second, whereas U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets, ASU No. 2011-04 extends that prohibition to all fair value measurements. Third, an exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity's net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position. Fourth, the fair value measurement of instruments classified within an entity's stockholders' equity has been aligned with the guidance for liabilities. Fifth, disclosure requirements have been enhanced for recurring Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The provisions of ASU No. 2011-04 are effective for the Company's interim reporting period beginning on or after December 15, 2011. The adoption of ASU No. 2011-04 is not expected to have a material impact on the Company's statements of income and condition.

Note 2 – Earnings Per Share

Basic earnings/(loss) per common share are calculated by dividing net income/(loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings/(loss) per common share are calculated by dividing net income/(loss) available to common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of stock-based awards and the warrant. There is no dilutive effect on the loss per share during loss periods. The following table provides information relating to the calculation of earnings/(loss) per common share:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
(In thousands, except per share data)	2011	2010	2011	2010
Net (loss) income available to common shareholders	$ (233)	$ 445	$(1,316)	$(1,117)
Weighted average shares outstanding - Basic	8,446	8,443	8,445	8,440
Dilutive effect of stock-based awards and warrant	-	-	-	-
Weighted average shares outstanding - Diluted	8,446	8,443	8,445	8,440
(Loss) earnings per common share - Basic	$ (0.03)	$ 0.05	$(0.16)	$(0.13)
(Loss) earnings per common share - Diluted	$ (0.03)	$ 0.05	$(0.16)	$(0.13)

The calculations of diluted earnings/(loss) per share for the three and six months ended June 30, 2011 each excluded seven thousand weighted average stock-based awards and that portion of a warrant to purchase 173 thousand weighted average shares of common stock because the effect of including them would have been antidilutive. The calculations of diluted earnings/(loss) per share for the three and six months ended June 30, 2010 each excluded nine thousand weighted average stock-based awards and that portion of a warrant to purchase 173 thousand weighted average shares of common stock because the effect of including them would have been antidilutive.

Note 3 – Investment Securities

The amortized cost and estimated fair values of investment securities are as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
June 30, 2011:				
Obligations of U.S. Government agencies and corporations	$47,375	$1,030	$6	$48,399
Mortgage-backed securities	56,430	1,398	68	57,760
Equity securities	565	18	-	583
Total	$104,370	$2,446	$74	$106,742
December 31, 2010:				
Obligations of U.S. Government agencies and corporations	$58,052	$921	$69	$58,904
Mortgage-backed securities	38,817	933	173	39,577
Equity securities	566	8	-	574
Total	$97,435	$1,862	$242	$99,055
Held-to-maturity securities:				
June 30, 2011:				
Obligations of states and political subdivisions	$6,529	$219	$1	$6,747
December 31, 2010:				
Obligations of states and political subdivisions	$6,727	$143	$19	$6,851

The amortized cost and estimated fair values of investment securities by maturity date at June 30, 2011 are as follows:

	Available for sale		Held to maturity	
(Dollars in thousands)	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$7,019	$7,191	$304	$307
Due after one year through five years	20,310	20,509	3,220	3,316
Due after five years through ten years	10,650	11,032	1,994	2,077
Due after ten years	65,826	67,427	1,011	1,047
	103,805	106,159	6,529	6,747
Equity securities	565	583	-	-
Total	$104,370	$106,742	$6,529	$6,747

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

The following table provides information about gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at June 30, 2011:

	Less than 12 Months		More than 12 Months		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-sale securities:						
U.S. Gov't. agencies and corporations	$1,369	$6	$-	$-	$1,369	$6
Mortgage-backed securities	14,640	68	-	-	14,640	68
Total	$16,009	$74	$-	$-	$16,009	$74

The available-for-sale securities have a fair value of approximately $106.7 million. Of these securities, approximately $16.0 million have unrealized losses when compared to their amortized cost. The securities with the unrealized losses in the available-for-sale portfolio all have modest duration risk, low credit risk, and minimal losses (approximately 0.07%) 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 debt 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, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary.

The following table provides information about gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at June 30, 2011:

	Less than 12 Months		More than 12 Months		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Held-to-maturity securities:						
Obligations of states and political subdivisions	$155	$1	$-	$-	$155	$1

The held-to-maturity securities have a fair value of approximately $6.7 million. Approximately $155 thousand of these securities have unrealized losses when compared to their amortized cost. All of the securities with unrealized losses in the held-to-maturity portfolio are municipal securities with modest duration risk, low credit risk, and minimal losses (approximately 0.02%) when compared to total amortized cost. The unrealized losses that exist are the result of market changes in interest rates since the 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, the Company considers that the unrealized losses in the held-to-maturity portfolio to be temporary.

Note 4 – Loans and allowance for credit losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in the Maryland counties of Talbot, Queen Anne's, Kent, Caroline and Dorchester and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at June 30, 2011 and December 31, 2010:

(Dollars in thousands)	June 30, 2011	December 31, 2010
Construction	$ 128,140	$ 143,952
Residential real estate	332,134	333,738
Commercial real estate	327,307	318,726
Commercial	74,485	82,787
Consumer	15,265	16,201
Total loans	877,331	895,404
Allowance for credit losses	(16,358)	(14,227)
Total loans, net	$ 860,973	$ 881,177

Loans include deferred costs net of deferred fees of $123 thousand at June 30, 2011 and $38 thousand at December 31, 2010.

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. 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). 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 allowance for credit losses.

Loans are evaluated on a case-by-case basis for impairment. Once the amount of impairment has been determined, the uncollectible portion is charged off. In some cases, a specific allocation within the allowance for credit losses is made until such time a charge-off is made. At June 30, 2011, impaired loans had been reduced by partial charge-offs totaling $9.2 million, or 15.9%, of the unpaid principal balance. In addition, $1.4 million in specific reserves were established against $6.7 million of impaired loans. At December 31, 2010, impaired loans had been reduced by partial charge-offs totaling $8.3 million, or 18.6%, of the unpaid principal balance. In addition, $203 thousand in specific reserves were established against $837 thousand of impaired loans.

A loan is considered a trouble debt restructuring if a concession is granted due to deterioration in a borrower's financial condition. At June 30, 2011 and December 31, 2010, the Company had troubled debt restructurings of $22.3 million and $21.4 million, respectively. Because these loans were performing in accordance with their modified terms, there were no specific reserves established against them.

Gross interest income of $1.4 million for the first six months of 2011, $2.1 million for fiscal year 2010 and $1.0 million for the first six months of 2010 would have been recorded if impaired loans had been current and performing in accordance with their original terms. No interest was recorded on such loans for the first six months of 2011 or 2010.

The following tables provide information on impaired loans by loan class as of June 30, 2011 and December 31, 2010.

(Dollars in thousands)	Unpaid principal balance	Recorded investment	Related allowance	Average recorded investment
June 30, 2011				
Impaired loans with no related allowance recorded:				
Construction	$ 23,938	$ 18,129	$ -	$ 16,916
Residential real estate	12,692	11,258	-	9,279
Commercial real estate	10,783	9,901	-	7,772
Commercial	2,768	2,423	-	2,919
Consumer	30	29	-	29
Total	50,211	41,740	-	36,915
Impaired loans with a related allowance recorded:				
Construction	-	-	-	-
Residential real estate	956	929	289	2,539
Commercial real estate	5,921	5,240	506	4,408
Commercial	567	567	567	629
Consumer	-	-	-	-
Total	7,444	6,736	1,362	7,576
Total impaired loans:				
Construction	23,938	18,129	-	16,916
Residential real estate	13,648	12,187	289	11,818
Commercial real estate	16,704	15,141	506	12,180
Commercial	3,335	2,990	567	3,548
Consumer	30	29	-	29
Total	$ 57,655	$ 48,476	$ 1,362	$ 44,491

(Dollars in thousands)	Unpaid principal balance	Recorded investment	Related allowance	Average recorded investment
December 31, 2010				
Impaired loans with no related allowance recorded:				
Construction	$ 22,643	$ 17,261	$ -	$ 17,784
Residential real estate	11,038	9,132	-	8,368
Commercial real estate	5,558	5,133	-	3,827
Commercial	4,305	3,845	-	2,793
Consumer	30	30	-	56
Total	43,574	35,401	-	32,828
Impaired loans with a related allowance recorded:				
Construction	-	-	-	1,596
Residential real estate	945	837	203	420
Commercial real estate	-	-	-	-
Commercial	-	-	-	398
Consumer	-	-	-	-
Total	945	837	203	2,414
Total impaired loans:				
Construction	22,643	17,261	-	19,380
Residential real estate	11,983	9,969	203	8,788
Commercial real estate	5,558	5,133	-	3,827
Commercial	4,305	3,845	-	3,191
Consumer	30	30	-	56
Total	$ 44,519	$ 36,238	$ 203	$ 35,242

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 and doubtful are adversely rated and are assigned higher risk ratings than favorably rated loans.

The following tables provide information on loan risk ratings as of June 30, 2011 and December 31, 2010.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
June 30, 2011						
Pass/Performing	$ 60,273	$ 265,824	$ 262,221	$ 64,992	$ 15,139	$ 668,449
Special mention	26,799	22,651	15,150	1,731	2	66,333
Substandard	22,939	30,067	34,409	4,686	95	92,196
Doubtful	-	1,405	386	86	-	1,877
Nonaccrual	18,129	12,187	15,141	2,990	29	48,476
Total	$ 128,140	$ 332,134	$ 327,307	$ 74,485	$ 15,265	$ 877,331

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
December 31, 2010						
Pass/Performing	$ 83,344	$ 283,895	$ 260,040	$ 73,502	$ 16,043	$ 716,824
Special mention	23,090	23,847	17,821	2,249	-	67,007
Substandard	20,257	13,752	35,732	3,088	128	72,957
Doubtful	-	2,275	-	103	-	2,378
Nonaccrual	17,261	9,969	5,133	3,845	30	36,238
Total	$ 143,952	$ 333,738	$ 318,726	$ 82,787	$ 16,201	$ 895,404

The following tables provide information on the aging of the loan portfolio as of June 30, 2011 and December 31, 2010.

	Accruing						
(Dollars in thousands)	Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Non-accrual	Total
June 30, 2011							
Construction	$ 110,011	$ -	$ -	$ -	$ -	$ 18,129	$ 128,140
Residential real estate	312,795	4,155	2,040	957	7,152	12,187	332,134
Commercial real estate	308,760	2,163	1,243	-	3,406	15,141	327,307
Commercial	70,663	274	532	26	832	2,990	74,485
Consumer	14,819	373	37	7	417	29	15,265
Total	$ 817,048	$ 6,965	$ 3,852	$ 990	$ 11,807	$ 48,476	$ 877,331

	Accruing						
(Dollars in thousands)	Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Non-accrual	Total
December 31, 2010							
Construction	$ 124,892	$ 1,691	$ 108	$ -	$ 1,799	$ 17,261	$ 143,952
Residential real estate	314,914	4,046	1,355	3,454	8,855	9,969	333,738

Commercial real estate	306,497	3,393	2,717	986	7,096	5,133	318,726
Commercial	77,833	470	465	174	1,109	3,845	82,787
Consumer	15,572	486	25	88	599	30	16,201
Total	$ 839,708	$ 10,086	$ 4,670	$ 4,702	$ 19,458	$ 36,238	$ 895,404

	Accruing Current		30-59 days past due		60-89 days past due		90 days or more past due		Total past due		Non-accrual	
June 30, 2011												
Construction	85.9	%	-	%	-	%	-	%	-	%	14.1	%
Residential real estate	94.1		1.3		0.6		0.3		2.2		3.7	
Commercial real estate	94.3		0.7		0.4		-		1.1		4.6	
Commercial	94.9		0.4		0.7		-		1.1		4.0	
Consumer	97.1		2.5		0.2		-		2.7		0.2	
Total	93.2		0.8		0.4		0.1		1.3		5.5	

	Accruing Current		30-59 days past due		60-89 days past due		90 days or more past due		Total past due		Non-accrual	
December 31, 2010												
Construction	86.8	%	1.1	%	0.1	%	-	%	1.2	%	12.0	%
Residential real estate	94.4		1.2		0.4		1.0		2.6		3.0	
Commercial real estate	96.2		1.0		0.9		0.3		2.2		1.6	
Commercial	94.0		0.6		0.6		0.2		1.4		4.6	
Consumer	96.1		3.0		0.2		0.5		3.7		0.2	
Total	93.8		1.2		0.5		0.5		2.2		4.0	

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 on a quarterly basis and adjusts the provision for credit losses based upon this analysis. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three months ended June 30, 2011 and 2010.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended June 30, 2011							
Allowance for credit losses:							
Beginning balance	$ 3,324	$ 5,420	$ 5,280	$ 2,776	$ 591	$ 80	$ 17,471
Charge-offs	(728)	(2,390)	(2,265)	(1,525)	(40)	-	(6,948)
Recoveries	-	34	5	380	21	-	440
Net charge-offs	(728)	(2,356)	(2,260)	(1,145)	(19)	-	(6,508)
Provision	937	1,120	2,231	1,079	33	(5)	5,395
Ending balance	$ 3,533	$ 4,184	$ 5,251	$ 2,710	$ 605	$ 75	$ 16,358

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended June 30, 2010							
Allowance for credit losses:							
Beginning balance	$ 3,035	$ 3,326	$ 3,806	$ 1,897	$ 516	$ 211	$ 12,791
Charge-offs	(681)	(2,525)	(46)	(1,164)	(145)	-	(4,561)
Recoveries							