NORTHEAST BANCORP /ME/
Form 10-Q
May 16, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15 (d) of

the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2011

Commission File Number: 1-14588

Northeast Bancorp

(Exact name of registrant as specified in its charter)

Maine	01-0425066
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization)	**Identification No.)**
500 Canal Street, Lewiston, Maine	**04240**
(Address of Principal executive offices)	**(Zip Code)**

(207) 786-3245

Registrant s telephone number, including area code

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ 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 definition of accelerated filer , large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller Reporting Company	x

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

As of May 11, 2011, the registrant had outstanding 3,311,173 shares of voting common stock, $1.00 par value per share, and 195,351 shares of non-voting common stock, $1.00 par value per share.

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PART 1- FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	Successor Company (1) March 31, 2011 (Unaudited)	Predecessor Company (2) June 30, 2010 (Audited)
Assets		
Cash and due from banks	$ 3,283	$ 7,019
Short-term investments	106,472	13,416
Total cash and cash equivalents	109,755	20,435
Available-for-sale securities, at fair value	127,227	164,188
Loans held-for-sale	8,378	14,254
Loans receivable		
Residential real estate	143,172	155,613
Commercial real estate	117,562	121,175
Construction	2,941	5,525
Commercial business	25,490	30,214
Consumer	23,891	69,782
Total loans, gross	313,056	382,309
Less allowance for loan losses	14	5,806
Loans, net	313,042	376,503
Premises and equipment, net	8,079	7,997
Acquired assets, net	753	1,292
Accrued interest receivable	1,375	2,081
Federal Home Loan Bank stock, at cost	4,889	4,889
Federal Reserve Bank stock, at cost	597	597
Intangible assets	13,344	11,371
Bank owned life insurance	13,667	13,286
Other assets	6,268	5,714
Total assets	$ 607,374	$ 622,607

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

(Continued)

	Successor Company (1) March 31, 2011 (Unaudited)	Predecessor Company (2) June 30, 2010 (Audited)
Liabilities and Stockholders Equity		
Liabilities:		
Deposits		
Demand	$ 45,254	$ 35,266
Savings and interest checking	90,379	89,024
Money market	52,226	55,556
Brokered time deposits	4,934	4,883
Certificates of deposit	208,571	199,468
Total deposits	401,364	384,197
Federal Home Loan Bank advances	43,974	50,500
Structured repurchase agreements	68,434	65,000
Short-term borrowings	13,226	46,168
Junior subordinated debentures issued to affiliated trusts	7,922	16,496
Capital lease obligation	2,114	2,231
Other borrowings	2,134	2,630
Other liabilities	3,317	4,479
Total liabilities	542,485	571,701
Commitments and contingent liabilities		
Stockholders equity		
Preferred stock, $1.00 par value, 1,000,000 shares authorized; 4,227 shares issued and outstanding at March 31, 2011 and June 30, 2010, liquidation preference of $1,000 per share	4	4
Voting common stock, at stated value, 13,500,000 and 15,000,000 shares authorized at March 31, 2011 and June 30, 2010, respectively; 3,310,173 and 2,323,832 shares issued and outstanding at March 31, 2011 and June 30, 2010, respectively	3,310	2,324
Non-voting common stock, at stated value, 1,500,000 and 0 shares authorized at March 31, 2011 and June 30, 2010, respectively; 195,351 and 0 shares issued and outstanding at March 31, 2011 and June 30, 2010, respectively	195	
Warrants	406	133
Additional paid-in capital	49,535	6,761
Unearned restricted stock award	(172)	
Retained earnings	11,579	37,338
Accumulated other comprehensive income	32	4,346
Total stockholders equity	64,889	50,906
Total liabilities and stockholders equity	$ 607,374	$ 622,607

See accompanying notes to unaudited consolidated financial statements

(1) Successor Company means Northeast Bancorp and its subsidiary after the closing of the merger with FHB Formation LLC on December 29, 2010.

(2) Predecessor Company means Northeast Bancorp and its subsidiary before the closing of the merger with FHB Formation LLC on December 29, 2010.

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(Dollars in thousands, except share and per share data)

	Successor Company (1)		Predecessor Company (2)		
	Three Months Ended March 31, 2011	93 Days Ended March 31, 2011	181 Days Ended Dec. 28, 2010	Three Months Ended March 31, 2010	Nine Months Ended March 31, 2010
Interest and dividend income:					
Interest on loans	$ 5,649	$ 5,845	$ 11,210	$ 5,960	$ 18,034
Taxable interest on available-for-sale securities	832	872	2,854	1,733	5,171
Tax-exempt interest on available-for-sale securities	71	75	231	121	356
Dividends on available-for-sale securities	7	7	26	19	46
Dividends on Federal Home Loan Bank and Federal Reserve Bank stock	12	13	18	9	27
Other interest and dividend income	33	34	39	2	10
Total interest and dividend income	6,604	6,846	14,378	7,844	23,644
Interest expense:					
Deposits	774	816	2,796	1,682	5,507
Federal Home Loan Bank advances	284	299	918	457	1,336
Structured repurchase agreements	249	272	1,392	692	2,172
Short-term borrowings	60	67	376	165	486
Junior subordinated debentures issued to affiliated trusts	174	180	340	182	587
Obligation under capital lease agreements	26	28	55	28	88
Other borrowings	35	35	75	43	156
Total interest expense	1,602	1,697	5,952	3,249	10,332
Net interest and dividend income before provision for loan losses	5,002	5,149	8,426	4,595	13,312
Provision for loan losses	49	49	912	628	1,504
Net interest and dividend income after provision for loan losses	4,953	5,100	7,514	3,967	11,808

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited) (Continued)

(Dollars in thousands, except share and per share data)

	Successor Company (1)		Predecessor Company (2)		
	Three Months Ended March 31, 2011	93 Days Ended March 31, 2011	181 Days Ended Dec. 28, 2010	Three Months Ended March 31, 2010	Nine Months Ended March 31, 2010
Noninterest income:					
Fees for other services to customers	310	323	698	350	1,116
Net securities gains (losses)	47	47	17	(63)	(20)
Gain on sales of loans	295	344	1,867	141	708
Investment commissions	709	734	1,174	467	1,455
Insurance commissions	1,458	1,495	2,661	1,741	4,705
BOLI income	126	131	250	125	376
Bargain purchase gain	296	15,216			
Other income	148	156	330	292	510
Total noninterest income	3,389	18,446	6,997	3,053	8,850
Noninterest expense:					
Salaries and employee benefits	4,824	4,991	6,670	3,469	10,392
Occupancy and equipment expense	903	930	1,556	907	2,566
Professional fees	378	387	527	211	797
Data processing fees	326	337	618	300	927
Intangible assets amortization	439	444	344	177	549
Merger expense	132	3,182	94	157	157
Other	1,337	1,455	2,138	1,051	3,052
Total noninterest expense	8,339	11,726	11,947	6,272	18,440
Income before income tax (benefit) expense	3	11,820	2,564	748	2,218
Income tax (benefit) expense	(153)	(171)	768	217	542
Net income	$ 156	$ 11,991	$ 1,796	$ 531	$ 1,676
Net income available to common stockholders	$ 58	$ 11,891	$ 1,677	$ 470	$ 1,493
Weighted-average shares outstanding					
Basic	3,492,498	3,492,498	2,330,197	2,322,332	2,321,726
Diluted	3,559,873	3,560,278	2,354,385	2,342,153	2,331,227
Earnings per common share:					
Basic	$ 0.02	$ 3.39	$ 0.72	$ 0.20	$ 0.64
Diluted	$ 0.02	$ 3.33	$ 0.71	$ 0.20	$ 0.64

See accompanying notes to unaudited consolidated financial statements

(1) Successor Company means Northeast Bancorp and its subsidiary after the closing of the merger with FHB Formation on LLC on December 29, 2010.

(2) Predecessor Company means Northeast Bancorp and its subsidiary before the closing of the merger with FHB Formation LLC on December 29, 2010.

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NORTHEAST BANCORP AND SUBSIDIARY

Consolidated Statements of Changes in Stockholders Equity

Periods Ended March 31, 2011, December 28, 2010 and March 31, 2010

(Unaudited)

(Dollars in thousands)

	Preferred Stock		Common Stock			Additional Paid-in	Unearned Restricted	Retained	Accumulated Other Comprehensive	
	Shares	Amount	Shares	Amount	Warrants	Capital	Stock	Earnings	Income	Total
Predecessor Company (2)										
Balance at June 30, 2009	4,227	$ 4	2,321,332	$ 2,321	$ 133	$ 6,709	$	$ 36,698	$ 1,451	$ 47,316
Net income for nine months ended March 31, 2010								1,676		1,676
Other comprehensive income net of tax:										
Net unrealized loss on purchased interest rate caps and swap									(125)	(125)
Net unrealized gain on investments available for sale, net of reclassification adjustment									2,006	2,006
Total comprehensive income										3,557
Dividends on preferred stock								(159)		(159)
Dividends on common stock at $0.27 per share								(626)		(626)
Stock options exercised			1,000	1		7				8
Accretion of preferred stock						20		(20)		
Amortization of issuance cost of preferred stock						4		(4)		
Balance at March 31, 2010	4,227	$ 4	2,322,332	$ 2,322	$ 133	$ 6,740	$	$ 37,565	$ 3,332	$ 50,096
Predecessor Company (2)										
Balance at June 30, 2010	4,227	$ 4	2,323,832	$ 2,324	$ 133	$ 6,761	$	$ 37,338	$ 4,346	$ 50,906
Net income for 181 days ended December 28, 2010								1,796		1,796
Other comprehensive income net of tax:										
Net unrealized loss on purchased interest rate caps and swap									(27)	(27)
Net unrealized gain on investments available for sale, net of reclassification adjustment									(1,863)	(1863)

Total comprehensive loss										(94)
Dividends on preferred stock								(106)		(106)
Dividends on common stock $0.18 per share								(419)		(419)
Stock options exercised			7,500	8		54				62
Accretion of preferred stock						13		(13)		
Amortization of issuance cost of preferred stock						3		(3)		
Balance at December 28, 2010	4,227	$ 4	2,331,332	$ 2,332	$ 133	$ 6,831	$	$ 38,593	$ 2,456	$ 50,349

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NORTHEAST BANCORP AND SUBSIDIARY

Consolidated Statements of Changes in Stockholders Equity

Periods Ended March 31, 2011, December 28, 2010 and March 31, 2010

(Dollars in thousands)

(Continued)

	Preferred Stock		Common Stock			Additional	Unearned		Other	
						Paid-in	Restricted	Retained	Comprehensive	
	Shares	Amount	Shares	Amount	Warrants	Capital	Stock	Earnings	Income	Total
Successor Company (1)										
Balance at December 29, 2010	4,227	$ 4	2,331,332	$ 2,332	$ 313	$ 34,128	$	$	$	$ 36,777
Net income for 93 days ended March 31, 2011								11,991		11,991
Other comprehensive income net of tax:										
Net unrealized loss on purchased interest rate caps and swap									66	66
Net unrealized gain on investments available for sale, net of reclassification adjustment									(34)	(34)
Total comprehensive income										12,023
Acquisition accounting adjustment										
Purchase accounting adjustment					93	(443)				(350)
Restricted stock award			13,026	13		168	(181)			
Voting common stock issued			965,815	965		12,489				13,454
Non-voting common stock issued			195,351	195		2,526				2,721
Dividends on preferred stock								(53)		(53)
Dividends on common stock at $0.09 per share								(314)		(314)
Amortization of preferred stock						45		(45)		
Stock award earned							9			9
SAR Option activity						526				526
Options expense						96				96
Balance at March 31, 2011	4,227	$ 4	3,505,524	$ 3,505	$ 406	$ 49,535	$ (172)	$ 11,579	$ 32	$ 64,889

(1) Successor Company means Northeast Bancorp and its subsidiary after the closing of the merger with FHB Formation on LLC on December 29, 2010.
(2) Predecessor Company means Northeast Bancorp and its subsidiary before the closing of the merger with FHB Formation LLC on December 29, 2010.

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NORTHEAST BANCORP AND SUBSIDIARY

Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Successor Company (1)	Predecessor Company (2)	
	93 days ended March 31, 2011	181 days ended Dec. 28, 2010	Nine months ended March 31, 2010
Cash flows from operating activities:			
Net income	$ 11,991	$ 1,796	$ 1,676
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Provision for loan losses	49	912	1,723
Provision for REO	56	113	
Provision made for deferred compensation	57	105	146
Write-down of available-for-sale securities			103
Write-down of non-marketable securities			99
Amortization of intangible assets	444	344	549
BOLI income, net	(131)	(250)	(376)
Depreciation of premises and equipment	281	520	813
Net securities gains	(47)	(17)	20
Net (gain) loss on sale of acquired assets	(1)	(16)	219
Net (gain) disposal, write-down and sale of fixed assets	(4)		117
Net (gain) loss on sale of insurance business		(104)	(235)
Net change in loans held-for-sale	(525)	6,401	(138)
Net amortization (accretion) of securities	301	90	(23)
Bargain purchase gain	(15,216)		
Change in other assets and liabilities:			
Interest receivable	585	121	53
Prepayment FDIC assessment			(2,498)
Decrease in prepayment FDIC assessment	159	120	158
Other assets and liabilities	(702)	(831)	894
Net cash (used in) provided by operating activities	(2,703)	9,304	3,300
Cash flows from investing activities:			
Proceeds from the sales of available-for-sale securities	64,588	173	1,312
Purchases of available-for-sale securities	(51,029)	(19,001)	(59,188)
Proceeds from maturities and principal payments on available-for-sale securities	10,706	26,805	38,462
Loan originations and principal collections, net	10,955	14,440	2,989
Proceed from sale of portfolio loans	36,829		
Purchases of premises and equipment	(463)	(490)	(645)
Proceeds from sales of premises and equipment	16	36	43
Proceeds from sales of acquired assets	184	483	418
Proceeds from sale of insurance businesses		154	534
Investment in low income tax credit			(1,031)
Net cash provided by (used in) investing activities	71,786	22,600	(17,106)

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NORTHEAST BANCORP AND SUBSIDIARY

Consolidated Statements of Cash Flows

(Unaudited) (Continued)

(Dollars in thousands)

	Successor Company (1)	Predecessor Company (2)	
	93 days ended March 31, 2011	181 days ended Dec. 28, 2010	Nine months ended March 31, 2010
Cash flows from financing activities:			
Net increase (decrease) in deposits	24,122	(9,580)	(5,022)
Advances from the Federal Home Loan Bank			12,500
Repayment of advances from the Federal Home Loan Bank	(8,000)		(2,000)
Net repayments on Federal Home Loan Bank overnight advances			(815)
Net (decrease) increase in short-term borrowings	(49,817)	16,875	7,020
Dividends paid	(367)	(525)	(785)
Issuance of common stock	16,175	62	8
Purchase of interest rate caps			(325)
Repayment on debt from insurance agencies acquisitions		(496)	(634)
Repayment on capital lease obligation	(39)	(77)	(110)
Net cash (used in) provided by financing activities	(17,926)	6,259	9,837
Net increase (decrease) in cash and cash equivalents	51,157	38,163	(3,969)
Cash and cash equivalents, beginning of period	58,598	20,435	13,022
Cash and cash equivalents, end of period	$ 109,755	$ 58,598	$ 9,053
Supplemental schedule of cash flow information:			
Interest paid	$ 2,971	$ 5,781	$ 10,550
Income taxes paid	28	846	340
Supplemental schedule of noncash investing and financing activities:			
Transfer from loans to acquired assets	$ 27	$ 346	$ 2,034
Transfer from acquired assets to loans		56	45
Change in valuation allowance for unrealized losses (gains) on available-for-sale securities, net of tax	(3,366)	(1,890)	1,881
Net change in deferred taxes for unrealized losses (gains) on available-for-sale securities	1,734	974	(1,033)

Additional supplemental information as a result of the merger on December 29, 2010 is disclosed in Note 2, Merger Transaction, in the Notes to Unaudited Consolidated Financial Statements.

See accompanying notes to unaudited consolidated financial statements

(1) Successor Company means Northeast Bancorp and its subsidiary after the closing of the merger with FHB Formation on LLC on December 29, 2010.
(2) Predecessor Company means Northeast Bancorp and its subsidiary before the closing of the merger with FHB Formation LLC on December 29, 2010.

NORTHEAST BANCORP AND SUBSIDIARY

Notes to Unaudited Consolidated Financial Statements

March 31, 2011

1. Basis of Presentation

The accompanying unaudited condensed and consolidated interim financial statements include the accounts of Northeast Bancorp (Northeast or the Company) and its wholly owned subsidiary, Northeast Bank (the Bank). These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting principally of normal recurring accruals) considered necessary for a fair presentation of the Company s financial position at March 31, 2011, the results of operations for the three-month and 93-day period ended March 31, 2010, the 181-day period ended December 28, 2010 and the three- and nine-month periods ended March 31, 2010, the changes in stockholders equity for the 93-day period ended March 31, 2011, the 181-day period ended December 28, 2010 and the nine-month period ended March 31, 2010, and the cash flows for the 93-day period ended March 31, 2011, the 181-day period ended December 28, 2010 and the nine-month period ended March 31, 2010. Operating results for the nine-month period ended March 31, 2011 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2011. For further information, refer to the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2010 included in the Company s Annual Report on Form 10-K.

2. Merger Transaction

On December 29, 2010, the merger of the Company and FHB Formation LLC (FHB) was consummated. FHB is the entity through which a group of independent accredited investors (the Investors) purchased 937,933 shares of the Company s outstanding common stock and 1,161,166 shares of newly-issued voting and non-voting common stock, at a price equal to $13.93 per share. As a result of this transaction, $16.2 million of new capital was contributed to the Company, and the Investors collectively own approximately 60% of the outstanding common shares of the Company. We have applied the acquisition method of accounting, as described in Accounting Standards Codification (ASC) 805, *Business Combinations,* to this transaction, which represents an acquisition by FHB of Northeast, with Northeast as the surviving company.

As a result of application of the acquisition method of accounting to the Company s balance sheet, the Company s financial statements from the periods prior to the transaction date are not directly comparable to the financial statements for periods subsequent to the transaction date. To make this distinction, we have labeled balances and results of operations prior to the transaction date as Predecessor Company and balances and results of operations for periods subsequent to the transaction date as Successor Company. The lack of comparability arises from the assets and liabilities having new accounting bases as a result of recording them at their fair values as of the transaction date rather than at historical cost basis. To denote this lack of comparability, the Company has placed a heavy black line between the Successor Company and Predecessor Company columns in the Consolidated Financial Statements and in the tables in the notes to the statements and in this discussion. In addition, the lack of comparability means that the periods being reported in the fiscal year ending June 30, 2011 in the statements and tables are not the same periods as reported for the fiscal year ended June 30, 2010.

Under the acquisition method of accounting, the Company assets acquired and liabilities assumed are recorded at their respective fair values as of the transaction date. In connection with the merger, the consideration paid, and the assets acquired and liabilities assumed recorded at fair value on the date of acquisition, are summarized in the following tables:

	(Dollars in Thousands)	
Consideration Paid:		
FHB investors purchase of 937,933 existing Northeast shares, at $13.93 per Surviving Company share	$	13,065
Existing Northeast shareholders retention of shares in Surviving Company, 1,393,399 shares at $13.93 per share		19,410

Total consideration paid:	$	32,475

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		(Dollars in Thousands)
Net Assets Acquired:		
Assets:		
Cash and short-term investments	$	58,598
Securities available for sale		153,315
Loans		369,498
Premises and equipment		7,905
Bank-owned life insurance		13,536
Core deposit intangible		5,924
Other identifiable intangibles		7,865
Other assets		14,409
	$	631,050
Liabilities and Preferred Equity:		
Deposits	$	378,523
Overnight borrowings		63,043
Term borrowings		125,409
Junior subordinated debentures issued to affiliated trusts		7,889
Other liabilities		4,400
Preferred stock		4,095
	$	583,359
Total identifiable net assets	$	47,691
Consideration paid	$	32,475
Bargain purchase gain recorded in income	$	15,216

In this transaction, the estimated fair values of the Company s net assets were greater than the purchase price. This resulted in a bargain purchase gain of $15.2 million in the 93-day period ended March 31, 2011. The transaction resulted in a gain principally because intangible asset fair values were identified totaling $13.7 million, while the purchase price paid by the Investors was based on the Company s tangible book value as of September 30, 2009. Direct costs associated with the merger were expensed by the Company as incurred. Through March 31, 2011, those expenses principally legal, accounting and investment banking fees amounted to $3.9 million, of which $3.3 million was incurred in the nine-month period ended March 31, 2011.

The fair value of the loan portfolio was $369.5 million, and included $4.6 million of loans with evidence of deterioration in credit quality since origination for which it is probable, as of the transaction date, that the Company will be unable to collect all contractually required payments receivable. In accordance with ASC 310-30 this resulted in a non-accretable difference of $1.9 million, which is defined as the loan s contractually required payments in excess of the amount of its cash flows expected to be collected. The Company considered factors such as payment history, collateral values, and accrual status when determining whether there was evidence of deterioration of a loan s credit quality at the transaction date. The Company s previously established allowance for loan losses was not carried forward in the determination of loan fair value.

The core deposit intangible asset recognized as part of the transaction is being amortized over its estimated useful life of 9.7 years. Existing goodwill totaling $4.1 million, recorded in conjunction with previous insurance agency acquisitions, was eliminated when determining the fair value of net assets. Other insurance agency identifiable intangibles, principally the value of agency customer lists, were appraised by an insurance valuation specialist.

The fair value of savings and transaction accounts was assumed to approximate their carrying value, since these deposits have no stated maturity and are payable upon demand. The fair values of certificates of deposit and term borrowings were determined by discounting their contractual cash flows at current market rates.

Commitments in Connection with Regulatory Approval of the Merger

The merger required the approval of the Maine Bureau of Financial Institutions (the Bureau) and the Board of Governors of the Federal Reserve System (the Federal Reserve). Those approvals contain certain commitments by the Company, including the following:

The Federal Reserve requires that Northeast (i) maintain a leverage ratio (Tier 1) of at least 10%, (ii) maintain a total risk-based capital ratio of at least 15%, (iii) limit purchased loans to 40% of total loans, (iv) fund 100% of

loans with core deposits, (v) hold commercial real estate loans (including owner-occupied commercial real estate) to within 300% of total risk-based capital, and (vi) amend the articles of incorporation to address certain technical concerns that the Federal Reserve had relating to the convertibility and transferability of non-voting common stock.

The Bureau requires that, for a two-year period, Northeast obtain the prior approval of the Bureau for any material deviation from the business plan. The Bureau s approval includes other conditions on capital ratios and loan purchasing that are either the same as or less stringent than those of the Federal Reserve.

The Company and the Bank are currently in compliance with all commitments to the Federal Reserve and Bureau.

3. Loans

The Company s loan portfolio includes residential real estate, commercial real estate, construction, commercial and consumer segments. Residential real estate loans include one- to four-family owner-occupied, second mortgages and equity lines of credit.

Consumer loans include personal and indirect loans for autos, boats and recreational vehicles. Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on all loans is discontinued at the time the loan is 90 days past due unless the credit is well secured and in process of collection. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual if collection of principal or interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual is reversed against interest income. The interest on these is accounted for on a cash basis or cost recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

The allowance for loan losses is evaluated on a regular basis by management. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance consists of general, allocated and unallocated components, as further described below.

General Component

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by the following loan segments: residential real estate, commercial real estate, construction, commercial and consumer. Management uses a rolling average of historical losses based on a time frame appropriate to capture the relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: levels/trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; and national and local economic trends and conditions. There were no changes in the Company s policies or methodology pertaining to the general component of the allowance for loan losses in the fiscal year ending June 30, 2011.

The qualitative factors are determined based on the various risk characteristics of each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

Residential real estate The Company generally does not originate loans with a loan-to-value ratio greater than 80 percent and does not originate subprime loans. All loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment.

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Commercial real estate Loans in this segment are primarily income-producing properties located in Maine and New Hampshire. The underlying cash flows generated by the properties may be adversely impacted by a downturn in the economy as evidenced by increased vacancy rates, which in turn, will have an effect on the credit quality in this segment. Management obtains rent rolls annually and monitors the cash flows of these loans.

Construction loans Loans in this segment primarily include speculative real estate development loans for which payment is derived from the sale of the property. Credit risk is affected by cost overruns, time to sell at an adequate price, and market conditions.

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

Consumer loans Loans in this segment are secured by autos, boats, recreational vehicles and deposits with the Bank, and are also unsecured. Repayment is dependent on the credit quality of the individual borrower.

Allocated Component

The allocated component relates to loans that are classified as impaired. Impairment is measured on a loan-by-loan basis for commercial, commercial real estate and construction loans by either the present value of expected future cash flows discounted at the loan s effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of that loan. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential real estate loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring agreement.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

The Company periodically may agree to modify the contractual terms of the loans. When a loan is modified and a concession is made to a borrower experiencing financial difficultly, the modification is considered a troubled debt restructuring (TDR). All TDRs are initially classified as impaired.

Unallocated Component

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

The following is a summary of the composition of loans at the dates indicated:

	Successor Company	Predecessor Company
	March 31, 2011	June 30, 2010
(Dollars in thousands)		
Residential real estate:		
One- to four-family	$ 92,627	$ 102,584
Second mortgages	25,299	27,316
Equity lines of credit	25,246	25,713
Commercial	117,562	121,175

Construction	2,941	5,525
Total mortgage loans on real estate	263,675	282,313
Commercial loans	25,490	30,214
Consumer installment loans	23,891	69,782
Total loans	313,056	382,309
Less: Allowance for loan losses	14	5,806
Loans, net	$ 313,042	$ 376,503

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The following table sets forth activity in the Company s allowance for loan losses for the periods indicated:

	Successor Company	Predecessor Company	
	93 Days Ended March 31, 2011	181 Days Ended December 28, 2010	Nine Months Ended March 31, 2010
(Dollars in thousands)			
Balance at beginning of period	$ 5,980	$ 5,806	$ 5,764
Add provision charged to operations	49	912	1,723
Recoveries on loans previously charged off	20	121	136
	6,049	6,839	7,623
Less: Loans charged off	55	859	1,700
Less: Allowance for loan losses eliminated in accordance with acquisition method of accounting	5,980		
Balance at end of period	$ 14	$ 5,980	$ 5,923

Further information pertaining to the allowance for loan losses at March 31, 2011 follows:

	Residential Real Estate	Commercial Real Estate	Construction	Commercial	Consumer	Unallocated
			(Dollars in thousands)			
Loans deemed to be impaired as of March 31, 2011	$ 48	$ 1,791	$	$ 933	$	$
Loans not deemed to be impaired as of March 31, 2011	$ 143,124	$ 115,771	$ 2,941	$ 24,557	$ 23,891	$

The following is a summary of past due and non-accrual loans at March 31, 2011:

			Past Due			
	30-59 Days	60-89 Days	90 Days or More	Total Past Due	Total Current	Non-Accrual Loans
			(Dollars in thousands)			
Residential Real Estate:						
Residential one- to four-family	$ 732	$ 933	$ 1,131	$ 2,796	$ 89,831	$ 1,315
Second mortgages			151	151	25,148	150
Equity lines of credit		47		47	25,199	38
Commercial real estate	957		699	1,656	115,918	3,511
Construction			121	121	2,820	121
Commercial	42	1	443	486	25,004	629
Consumer	952	289	556	1,797	22,094	555
Total	$ 2,683	$ 1,270	$ 3,101	$ 7,054	$ 306,014	$ 6,319

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The following table provides additional information on impaired loans at March 31, 2011:

	Recorded Investments	Unpaid Principal Balance (1)	Allowance
		(Dollars in thousands)	
Impaired loans without a valuation allowance:			
Residential real estate:			
Residential one- to four-family	$ 48	$ 48	$
Commercial real estate	1,791	1,791	
Commercial	933	933	
Total	2,772	2,772	
Impaired loans with a valuation allowance:			
Residential real estate:			
Residential one- to four-family			
Commercial real estate			
Commercial			
Total			
Total impaired loans	$ 2,772	$ 2,772	$

(1) Impaired loans are presented net of the fair value adjustments of $1.79 million resulting from the application of the acquisition method of accounting in connection with the merger on December 29, 2010.

The following is a summary of information pertaining to impaired loans at March 31, 2011:

	Successor Company	Predecessor Company	
	93 Days Ended March 31, 2011	181 Days Ended December 28, 2010	Nine months Ended March 31, 2010
(Dollars in thousands)			
Average investment in impaired loans:			
Residential one- to four-family	$ 12	$ 330	$ 244
Commercial real estate	1,715	3,366	5,373
Commercial	976	1,738	2,723
Total average investment in impaired loans	$ 2,703	$ 5,434	$ 8,340
Interest income recognized on impaired loans:			
Residential one- to four-family	$ 1	$ 2	$ 3
Commercial real estate	30	76	220
Commercial	16	20	86

Total interest income recognized on impaired loans	$	47	$	98	$	309
Interest income recognized on a cash basis:						
on impaired loans:						
Residential one- to four-family	$	1	$	2	$	3
Commercial real estate		30		76		220
Commercial		16		20		86
Total interest income recognized a cash basis on impaired loans:	$	47	$	98	$	309

No additional funds were committed to be advanced in connection with impaired loans.

Credit Quality Information

The Company utilizes an eight point internal loan rating system for commercial real estate, construction and commercial loans as follows:

Loans rated 1 4: Loans in these categories are considered pass rated loans with low to average risk.

Loans rated 5: Loans in this category are considered special mention. These loans are beginning to show signs of potential weakness and are being closely monitored by management.

Loans rated 6: Loans in this category are considered substandard. Generally, a loan is considered substandard if the current net worth inadequately protects it and the paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.

Loans rated 7: Loans in this category are considered doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current existing facts, highly questionable and improbable.

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Loans rated 8: Loans in this category are considered loss and of such little value that their continuance as loans is not warranted.

On an annual basis, or more often if needed, the Company formally reviews the ratings on all commercial real estate, construction and commercial loans. Semi-annually, the Company engages an independent third-party to review a significant portion of loans within these segments. Management uses the results of these reviews as part of its annual review process.

The following table presents the Company s loans by risk rating at March 31, 2011.

	Commercial Real Estate	Construction	Commercial
		(Dollars in thousands)	
Loans rated 1-5	$ 105,372	$ 2,941	$ 22,211
Loans rated 6	12,190		3,279
Loans rated 7			
Loans rated 8			
	$ 117,562	$ 2,941	$ 25,490

4. Junior Subordinated Debentures Issued to Affiliated Trust

NBN Capital Trust II and NBN Capital Trust III were formed in December 2003, and NBN Capital Trust IV was formed in December 2004, to issue and sell common and trust preferred securities, using the proceeds to acquire Junior Subordinated Deferrable Interest Notes (Junior Subordinated Debentures) from the Company. The Junior Subordinated Debentures are the sole assets of each of the trusts.

The following table summarizes the Junior Subordinated Debentures and the common and trust preferred securities issued by each affiliated trust at March 31, 2011. The Company has the right to redeem the Junior Subordinated Debentures at the redemption price specified in the associated Indenture, plus accrued but unpaid interest to the redemption date.

Affiliated Trusts	Balances At Fair Value	Contractual Obligations	Interest Rate	Maturity Date
	(Dollars in thousands)			
NBN Capital Trust II	$ 1,716	$ 3,093	3.11%	March 30, 2034
NBN Capital Trust III	1,716	3,093	3.11%	March 30, 2034
NBN Capital Trust IV	4,490	10,310	2.20%	February 23, 2035
Total	$ 7,922	$ 16,496	2.54%	

NBN Capital Trust II and NBN Capital Trust III pay a variable rate based on three month LIBOR plus 2.80%, and NBN Capital Trust IV pays a variable rate based on three month LIBOR plus 1.89%. Accordingly, the trust preferred securities of the trusts currently pay quarterly distributions at an annual rate of 3.11% for the stated liquidation amount of $1,000 per preferred security for NBN Capital Trust II and NBN Capital Trust III and an annual rate of 2.20% for the stated liquidation amount of $1,000 per preferred security for NBN Capital Trust IV. The Company has fully and unconditionally guaranteed all of the obligations of each trust. The guaranty covers the quarterly distributions and payments on liquidation or redemption of the trust preferred securities, but only to the extent of funds held by the trusts. Based on the current rates and the impact of the interest rate swap referred to below, the annual interest expense on the trust preferred securities is approximately $676 thousand.

During the twelve months ended June 30, 2010, the Company purchased two interest rate caps and an interest rate swap to hedge the interest rate risk on notional amounts of $3 million, $3 million and $10 million, respectively, of the Junior Subordinated Debentures. Each was a cash flow

hedge to manage the risk to net interest income during a period of rising rates.

The notional amount of $3 million for each interest rate cap represents the outstanding junior subordinated debt from each trust. The strike rate is 2.505%. The Company will recognize higher interest expense on the Junior Subordinated Debentures for the first 200 basis points increase in three-month LIBOR. Once three-month LIBOR rate exceeds 2.505% on a quarterly reset date, there will be a payment by the counterparty to the Company at the following quarter end. The effective date of the purchased interest rate caps was September 30, 2009 and the caps mature in five years.

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The interest rate swap hedges Junior Subordinated Debentures resulting from the issuance of trust preferred stock by our affiliate NBN Capital Trust IV. The notional amount of $10 million represents the outstanding Junior Subordinated Debentures from this trust. Under the terms of the interest rate swap, Northeast pays a fixed rate of 4.69% quarterly for a period of five years from the effective date of February 23, 2010. We receive quarterly interest payments of three month LIBOR plus 1.89% over the same term.

See Note 13 for additional information on derivatives.

5. Securities

Securities available-for-sale at amortized cost and approximate fair values at March 31, 2011 and June 30, 2010 are summarized below:

	Successor Company March 31, 2011		Predecessor Company June 30, 2010	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)			
Debt securities issued by U.S. Government-sponsored enterprises	$ 27,166	$ 27,165	$ 8,583	$ 8,649
Mortgage-backed securities	99,513	99,377	126,538	133,862
Municipal bonds			11,905	12,007
Collateralized mortgage obligations			7,331	7,423
Corporate bonds			994	1,030
Equity securities	197	212	1,044	776
Trust preferred securities	401	473	584	441
	$ 127,277	$ 127,227	$ 156,979	$ 164,188

The gross unrealized gains and unrealized losses on available-for-sale securities are as follows:

	Successor Company March 31, 2011		Predecessor Company June 30, 2010	
	Gross Unrealized Gains	Gross Unrealized Losses	Gross Unrealized Gains	Gross Unrealized Losses
	(Dollars in thousands)			
Debt securities issued by U.S. Government-sponsored enterprises	$ 9	$ 10	$ 66	$
Mortgage-backed securities	203	339	7,327	3
Municipal bonds			166	64
Collateralized mortgage obligations			92	
Corporate bonds			36	
Equity securities	16	1	5	273
Trust preferred securities	84	12		143
	$ 312	$ 362	$ 7,692	$ 483

The following summarizes the Company s gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2011 and June 30, 2010:

Less than 12 Months	More than 12 Months	Total

	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(Dollars in thousands)			
March 31, 2011:						
Debt securities issued by U.S. Government-sponsored enterprises	$ 19,165	$ 10	$	$	$ 19,168	$ 10
Mortgage-backed securities	39,353	339			39,562	339
Equity securities	1	1			1	1
Trust preferred securities	74	12			72	12
	$ 58,593	$ 362	$	$	$ 58,803	$ 362

	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(Dollars in thousands)			
June 30, 2010:						
Mortgage-backed securities	$ 161	$ 3	$	$	$ 161	$ 3
Municipal bonds	2,608	20	830	44	3,438	64
Equity securities	190	10	473	263	663	273
Trust preferred securities	95	1	339	142	434	143
	$ 3,054	$ 34	$ 1,642	$ 449	$ 4,696	$ 483

Management of the Company, in addition to considering current trends and economic conditions that may affect the quality of individual securities within the Company s investment portfolio, also considers the Company s ability and intent to hold such securities to maturity or recovery of cost. Management does not believe any of the Company s available-for-sale securities are other-than-temporarily impaired at March 31, 2011, except as discussed below.

Based on management s assessment of available-for-sale securities, there has not been another-than-temporary decline in market value of certain trust preferred and equity securities for the nine months ended March 31, 2011. During the nine months ended March 31, 2010, write-downs of available-for-sale securities was $103 thousand and are included in other noninterest expense in the consolidated statements of income.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis and more frequently when economic or market conditions warrant such evaluation. The investment securities portfolio is generally evaluated for other-than-temporary impairment under ASC 320-10, *Investments Debt and Equity Securities*.

The Company adopted the provisions of ASC 320-10 for the year ended June 30, 2009, which was applied to existing and new debt securities held by the Company as of April 1, 2009. For those debt securities for which the fair value of the security is less than its amortized cost, the Company does not intend to sell such security, and because it is more likely than not that it will not be required to sell such security prior to the recovery of its amortized cost basis less any credit losses, ASC 320-10 requires that the credit component of the other-than-temporary impairment losses be recognized in earnings while the noncredit component is recognized in other comprehensive income, net of related taxes.

There were no other-than-temporary impairment losses on securities for the nine months ended March 31, 2011.

The amortized cost and fair values of available-for-sale debt securities at March 31, 2011 and June 30, 2010, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	March 31, 2011		June 30, 2010	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
		(Dollars in thousands)		
Due in one year or less	$	$	$ 994	$ 1,030
Due after one year through five years	27,166	27,165	5,000	5,012
Due after five years through ten years			4,750	4,804
Due after ten years	401	473	11,323	11,282
Mortgage-backed securities[1]	99,513	99,377	133,868	141,284
	$ 127,080	$ 127,015	$ 155,935	$ 163,412

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6. Advances from the Federal Home Loan Bank

A summary of borrowings from the Federal Home Loan Bank is as follows:

March 31, 2011			
Amounts At Fair Value	Principal Amounts Due	Interest Rates	Maturity Dates For Periods Ended March 31,
(Dollars in thousands)			
$10,240	$ 10,000	2.55% - 2.59%	2013
5,273	5,000	3.99	2014
12,790	12,500	2.91 3.08	2015
10,491	10,000	4.26	2017
5,180	5,000	4.29	2018
$43,974	$ 42,500		

June 30, 2010		
Principal Amounts Due	Interest Rates	Maturity Dates For Periods Ended June 30,
(Dollars in thousands)		
$ 3,000	4.99%	2011
5,000	3.99	2012
15,000	2.55 3.99	2013
12,500	2.91 3.08	2015
10,000	4.26	2017
5,000	4.29	2018
$ 50,500		

The Federal Home Loan Bank had the option to call $25 million of the outstanding advances at March 31, 2011. The options are continuously callable quarterly until maturity.

7. Structured Repurchase Agreements

A summary of outstanding structured repurchase agreements is as follows:

March 31, 2011						
Amounts At Fair Value	Principal Amounts Due	Interest Rate	Imbedded Cap/Floor	Amount of Cap/Floor	Strike Rate	Maturity
(Dollars in thousands)						

$21,037	$ 20,000	4.68%	Purchased Caps	$ 40,000	Expired	August 28, 2012
10,420	10,000	3.98%	Sold Floors	$ 20,000	Expired	August 28, 2012
10,518	10,000	4.18%	Purchased Caps	$ 10,000	Expired	December 13, 2012
10,624	10,000	4.30%	Purchased Caps	$ 10,000	3.79%	July 3, 2013
10,705	10,000	4.44%	Purchased Caps	$ 10,000	3.81%	September 23, 2015
5,130	5,000	2.86%	None			March 25, 2014
$68,434	$ 65,000					

June 30, 2010					
		Imbedded	Amount of		
Amount	Interest Rate	Cap/Floor	Cap/Floor	Strike Rate	Maturity
			(Dollars in thousands)		
$20,000	4.68%	Purchased Caps	$40,000	Expired	August 28, 2012
10,000	3.98%	Sold Floors	$20,000	Expired	August 28, 2012
10,000	4.18%	Purchased Caps	$10,000	4.88%	December 13, 2012
10,000	4.30%	Purchased Caps	$10,000	3.79%	July 3, 2013
10,000	4.44%	Purchased Caps	$10,000	3.81%	September 23, 2015
5,000	2.86%	None			March 25, 2014
$65,000					

No leveraging strategies were implemented in the fiscal year ending June 30, 2011. For the leveraging strategies implemented in the fiscal year ended June 30, 2009, the Company pledged mortgage-backed securities of $28.2 million, at inception, as collateral for $25 million borrowed in three transactions. The transactions maturing July 2013 and September 2015 of $10 million each had imbedded interest rate caps as summarized in the table above. The interest rate caps reduced our balance sheet risk to rising interest rates. They cannot be called by the issuer during the three years ended July 3, 2011 and during the four years ended September 23, 2012, respectively. Each agreement can be called quarterly thereafter. The transaction in March 2009, which did not have imbedded interest rate caps or floors, allowed the Company to extend its funding at a favorable interest rate. The issuer has no call option unless the Company no longer maintains regulatory well-capitalized status or is subject to a regulatory cease and desist order. Interest is paid quarterly. The interest rates are fixed for the term of the three agreements.

The Company is subject to margin calls on each transaction to maintain the necessary collateral in the form of cash or mortgage-backed securities during the borrowing term.

Payments would be received on the interest rate caps when three-month LIBOR exceeds the strike rate on the quarterly reset date. The amount of the payment would be equal to the difference between the strike rate and three-month LIBOR multiplied by the notional amount of the cap to be made 90 days after the reset date. The purchased interest rate caps expire at the end of the non-call periods noted above.

The collateral pledged for these borrowings consists of Federal National Mortgage Association, Federal Home Loan Mortgage Corporation and Government National Mortgage Association issued mortgage-backed securities with a fair value of $56.3 million and cash of $17.6 million as of March 31, 2011.

8. Stock-Based Compensation and Employee Benefits

Stock-Based Compensation

In connection with the transaction with FHB, the Company adopted the Northeast Bancorp 2010 Stock Option and Incentive Plan (the Plan), which provides for awards of stock-based compensation, including options, stock appreciation rights, restricted stock and other equity-based incentive awards. The maximum number of authorized shares of stock that may be issued under the plan is 810,054 shares. The Company s previous stock option plans were terminated on the transaction date, and 10,500 outstanding vested options under those plans were exchanged for options to acquire shares of surviving company common stock, with terms that are substantially identical to the existing options.

On December 29, 2010, the Company granted an award of 13,026 shares of restricted stock to a senior executive in the Company s Northeast Community Banking Division (NCBD). The holder of this award participates fully in the rewards of stock ownership of the Company, including voting rights and dividend rights. This award has been determined to have a fair value of $13.93 per share, based on the average price at which the Company s common stock traded on the date of grant. Forty percent of the award will vest on December 29, 2012, and the remainder will vest in three equal annual installments commencing on December 29, 2013.

On December 29, 2010, the Company awarded options to purchase 594,039 shares of the Company s common stock from the Plan to certain officers of the Company and/or the Bank. 259,218 of these options vest ratably over a five-year period, and have been determined to have a fair value of $3.85 per share. 21,601 options vest ratably over a three-year period, and have been determined to have a fair value of $3.85 per share. 10,801 options vest ratably over a four-year period, and have been determined to have a fair value of $3.85 per share. 64,803 options vest ratably over years three through five, and have been determined to have a fair value of $3.85 per share. 237,616 of these options are performance-based, and have been divided into three tranches, each of which will vest if certain qualitative conditions are satisfied and the Company s stock price exceeds a specified hurdle price for a period of 50 of the previous 75 consecutive trading days. The performance-based options have been determined to have a fair value of $2.43 per share. The strike price for all awards is $13.93 per share, based on the average price at which the Company s common stock traded on the date of grant. All have a contractual life of 10 years from the date of grant, and are subject to recoupment if (i) the Board determines that gross negligence, intentional misconduct or fraud by the awardee caused or was a significant contributing factor to a materially adverse restatement of the Company s financial statements and (ii) the vesting of an award was calculated or contingent upon the achievement of financial or operating results that were affected by the restatement and the vesting would have been less had the financial statements been correct.

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The Company assumed a liability in the amount of $509,000 from FHB for the estimated cost of stock appreciation rights (SARs) with respect to 162,010 shares, awarded on December 29, 2010 to two individuals who had been actively involved with FHB from its inception in February 2009. 81,004 of the SARs were subject to certain time-based restrictions on exercisability (the Time-Based SARs), and 81,006 of the SARs were subject to certain performance-based restrictions on exercisability (the Performance-Based SARs). Following the amendment of the Company s articles of incorporation on March 21, 2011, the Compensation Committee of the Company voted to accelerate the exercisability of the Time-Based SARs. The Time-Based SARs became immediately exercisable and were exercised on March 24, 2011. In connection with the exercise of the Time-Based SARs, the Company issued options to purchase 81,004 shares of the Company s non-voting common stock with an exercise price of $14.52 per share. The option shares will become exercisable in five equal annual installments commencing on December 29, 2010. In addition, the Company entered into certain Amended and Restated Performance-Based Appreciation Rights Agreements, pursuant to which the Performance-Based SARs will become automatically exercisable (and shall be exercised) for $0.59 per share in the event that relevant performance thresholds are satisfied. In connection with the Amended and Restated Performance-Based Appreciation Rights Agreements, the Company issued options to purchase 81,006 shares of the Company s non-voting common stock with an exercise price of $14.52 per share. The options will become exercisable upon the satisfaction of certain performance conditions. The net effect of the exercise of the Time-Based SARs and the execution of the Amended and Restated Performance-Based Appreciation Rights Agreements, together with the option issuance, on operating results for the quarter ended March 31, 2011 was $113 thousand, included in merger expense.

At March 31, 2011, none of the restricted stock, option or Performance-Based SAR awards granted on December 29, 2010 were exercisable.

Employee Benefits:

In connection with the merger, the Company entered into one-year employment agreements with four senior executives in the NCBD. In addition, three senior executives in the NCBD received retention payments equal to one year s base salary, aggregating $450 thousand, paid in the quarter ended March 31, 2011.

In connection with the merger, the Company entered into three-year employment agreements with its Chief Executive Officer, Chief Administrative Officer and Chief Financial Officer. These provide for a base salary, annual bonuses as determined by the Compensation Committee, participation in Company-wide benefit programs, and also contain noncompetition and nonsolicitation restrictions.

Refer to the Note 13 in the Company s Annual Report on Form 10-K for fiscal year ended June 30, 2010 for further information about the Company s employee benefits.

9. Capital Lease

In fiscal year 2006, the Company recognized a capital lease obligation for its new headquarters known as the Southern Gateway building located at 500 Canal Street, Lewiston, Maine. The present value of the lease payments over fifteen years ($264 thousand per year for each of the initial ten years of the lease term and $306 thousand per year for each of the last five years) exceeded 90% of the fair value of the Southern Gateway building. The Bank s commercial lending and underwriting, consumer loan underwriting, loan servicing, deposit operations, accounting, human resources, risk management, and executive administration departments occupy the approximately 27 thousand square feet of space.

The future minimum lease payments over the remaining term of the lease and the outstanding capital lease obligations at March 31, 2011 are as follows:

	(Dollars in thousands)
2011	$ 264
2012	264
2013	264
2014	264
2015	292
2016 and thereafter	1,328
Total minimum lease payments	2,676
Less imputed interest	562

Capital lease obligation	$ 2,114

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10. Insurance Agency Acquisitions

Northeast Bank Insurance Group, Inc., a subsidiary of the Bank, acquired one insurance agency in the fiscal year ended June 30, 2009, three insurance agencies in the fiscal year ended June 30, 2008 and four insurance agencies in the fiscal year ended June 30, 2007. Each acquisition was made as a purchase of assets for cash and a note, with the exception of the Palmer Insurance Agency (Palmer), which was the purchase of stock for cash and a note, and the Goodrich Insurance Associates (Goodrich), which was a purchase of assets for cash. Each agency operates at the location being used at the time of the acquisition except Goodrich, which was relocated to our agency office in Berwick, Maine; Hartford Insurance Agency (Hartford), which was relocated to our agency office in Auburn, Maine; and Russell Insurance Agency (Russell), which was relocated to the agency office in Anson, Maine.

All acquisitions were accounted for using the purchase method of accounting and resulted in increases in goodwill and customer list and non-compete intangibles on the consolidated balance sheet. All purchase and sale agreements, except the agreements relating to the Russell and Hartford, call for a reduction in the purchase price should the stipulated minimum commission revenue levels not be attained over periods of one to three years from the purchase date. During the year ended June 30, 2008, other borrowings and goodwill related to the Southern Maine Insurance Agency (Southern Maine) acquisition were reduced by $98.3 thousand in accordance with this stipulation. The customer list intangibles and estimated useful lives are based on estimates from a third-party appraiser. The useful lives of these intangibles range from eleven to twenty-four years. Non-compete intangible useful lives are amortized over a range of ten to fifteen years.

The debt incurred is payable to the seller of each agency. Each note bears an interest rate of 6.50% over terms as follows: the Palmer debt is payable over a term of seven years; the Sturtevant and Ham, Inc. (Sturtevant) debt is payable over a term of three years; the Southern Maine debt is payable over a term of four years; and the Russell debt is payable over a term of two years. Hartford, Spence & Matthews, and Hyler are payable over a term of seven years. Hartford, Spence & Matthews, Inc. (Spence & Matthews), and Hyler Agency (Hyler) have debt of $100 thousand, $800 thousand, and $200 thousand, respectively, which bears no interest and has been recorded at its present value assuming a discount rate of 6.50%. The Bank guaranteed the debt repayment to each seller.

Northeast Bank Insurance Group, Inc. leases the office locations for Sturtevant, Southern Maine and Hyler, which are operating leases. The Bank acquired Palmer s agency building and land in January 2007.

The results of operations of all agencies have been included in the consolidated financial statements since their acquisition date. There is no pro-forma disclosure included because the agencies individually, and in aggregate, were not considered significant acquisitions.

Purchase price	Acquisitions 2009	2008
	(Dollars in thousands)	
Cash paid	$ 715	$ 3,701
Debt incurred		2,824
Acquisition costs	3	37
Total	$ 718	6,562
Allocation of purchase price:		
Goodwill	$ 100	1,545
Customer list intangible	480	3,905
Non-compete intangible	135	1,100
Fixed and other assets	3	12
Total	$ 718	$ 6,562

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In conjunction with the application of acquisition accounting for the recent merger, goodwill previously recorded for insurance agency acquisitions was eliminated.

Northeast Bank Insurance Group, Inc. acquired Solon-Anson Insurance Agency, Inc. on September 29, 2004. This acquisition was accounted for using the purchase method and resulted in a customer list intangible asset of $2.1 million which is being amortized over twelve years.

The customer list of our Mexico, Maine insurance agency office was sold to UIG, Inc. on December 31, 2009. The customer list and certain fixed assets of our Rangeley, Maine insurance agency office were sold to Morton & Furbish Insurance Agency on January 31, 2010. Since these offices were part of the Solon-Anson Insurance Agency, Inc. acquired on September 29, 2004, the customer list intangibles were allocated based upon the gross commission revenues for the Mexico and Rangeley offices as a percentage of the total commission revenue of the Solon-Anson Insurance Agency, Inc. The land and buildings in Mexico and Rangeley have been listed for sale by Northeast Bank Insurance Group, Inc. Impairment expense of $46 thousand and $91 thousand was recognized for the Mexico and Rangeley buildings, respectively, in order to adjust the carrying values to the expected sales price in the fiscal year ended June 30, 2010. The Rochester, New Hampshire office was closed in May, 2010, and servicing of customer accounts from that office was transferred to the Berwick, Maine office. The customer list, certain fixed assets and the office lease of the Jackman office were sold to World-Wide Risk Management Inc. on December 22, 2010.

The following summarizes entries made to record the sale for the nine months ended March 31, 2011:

	Jackman (Dollars in thousands)
Sale price	$ 154
Allocated customer list, net of amortization	44
Fixed assets, net of accumulated depreciation	6
Gain recognized	$ 104

The following summarizes entries made to record the sales for the year ended June 30, 2010:

	Mexico	Rangeley
	(Dollars in thousands)	
Sale price	$ 270	$ 280
Allocated customer list, net of amortization	154	146
Fixed assets, net of accumulated depreciation		5
Gain recognized	$ 116	$ 129

11. Earnings Per Share (EPS)

EPS is computed by dividing net income allocated to common stockholders by the weighted average common shares outstanding. Net income allocated to common stockholders represents net income less income allocated to participating securities (see discussion below). Diluted earnings per common share is computed by dividing income allocated to common stockholders by the weighted average common shares outstanding plus amounts representing the dilutive effect of stock options outstanding and restricted stock, if applicable.

On July 1, 2009, the Company adopted new accounting guidance on earnings per share that defines unvested share-based payment awards that contain nonforfeitable rights to dividends as participating securities that are included in computing EPS using the two-class method. The two-class method is an earnings allocation formula and participating rights in undistributed earnings. Under this method, all earnings (distributed and undistributed) are allocated to participating securities and common shares based on their respective rights to receive dividends.

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	Successor Company		Predecessor Company		
	Three Months Ended Mar. 31, 2011	93 Days Ended Mar. 31, 2011	181 Days Ended Dec. 28, 2010	Three Months Ended Mar. 31, 2010	Nine Months Ended Mar. 31, 2010
Earnings per common share					
Net Income	$ 156	$ 11,991	$ 1,796	$ 531	$ 1,676
Preferred stock dividends	(53)	(55)	(104)	(53)	(159)
Accretion of preferred stock	(44)	(44)	(13)	(7)	(20)
Amortization of issuance costs	(1)	(1)	(2)	(1)	(4)
Net income available to common shareholders	$ 58	$ 11,891	$ 1,677	$ 470	$ 1,493
Dividends and undistributed earnings allocated to unvested shares of stock awards		(44)			
Net income applicable to common shareholders	$ 58	$ 11,847	$ 1,677	$ 470	$ 1,493
Average common shares issued and outstanding	3,492,498	3,492,498	2,330,197	2,322,332	2,321,726
Earnings per common share	$ 0.02	$ 3.39	$ 0.72	$ 0.20	$ 0.64
Diluted earnings per Common share					
Net income applicable to common shareholders	$ 58	$ 11,891	$ 1,677	$ 470	$ 1,493
Dividends and undistributed earnings allocated to unvested shares of stock awards		(44)			
Net income available to common shareholders	$ 58	$ 11,847	$ 1,677	$ 470	$ 1,493
Average common shares issued and outstanding	3,492,498	3,492,498	2,330,197	2,322,332	2,321,726
Dilutive potential common shares	67,375	67,780	24,188	19,821	7,366
Total diluted average common shares issued and outstanding	3,559,873	3,560,278	2,354,385	2,342,153	2,329,092
Diluted earnings per common share	$ 0.02	$ 3.33	$ 0.71	$ 0.20	$ 0.64

12. Fair Value Measurements

In accordance with ASC 820, *Fair Value Measurements,* the Company groups its assets and liabilities measured 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 fair value.

Level 1 - Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury and other U.S. Government-sponsored enterprise securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities.

Level 3 - Valuations for assets and liabilities that are derived from other methodologies, including option pricing models, discounted cash flow models and similar techniques, are not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets and liabilities.

A financial instrument s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

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A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company s financial assets and financial liabilities carried at fair value at March 31, 2011 and June 30, 2010.

The Company s exchange traded equity securities are generally classified within level 1 or level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency.

The Company s investment in municipal, corporate and agency bonds and mortgage-backed securities available-for-sale is generally classified within level 2 of the fair value hierarchy. For these securities, we obtain fair value measurements from independent pricing services. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trading levels, market consensus prepayment speeds, credit information and the instrument s terms and conditions.

Level 3 is for positions that are not traded in active markets or are subject to transfer restrictions: valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management s best estimate is used. Subsequent to initial valuation, management only changes level 3 inputs and assumptions when evidence such as transactions in similar instruments, completed or pending third-party transactions in the underlying investment or comparable entities, subsequent rounds of financing, recapitalization and other transactions across the capital structure, offerings in the equity or debt markets, and changes in financial ratios or cash flows indicates that initial valuation needs to be updated.

The Company did not have any significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy during the nine months ended March 31, 2011.

The following summarizes assets measured at fair value for the period ended March 31, 2011 and June 30, 2010.

Assets Measured At Fair Value On A Recurring Basis

		Fair Value Measurements at Reporting Date Using:		
March 31, 2011:	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
		(Dollars in thousands)		
Securities available-for-sale	$ 127,227	$ 685	$ 126,542	$
Other assets purchased interest rate caps	99		99	

		Fair Value Measurements at Reporting Date Using:		
June 30, 2010:	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
		(Dollars in thousands)		
Securities available-for-sale	$ 164,188	$ 3,717	$ 160,471	$
Other assets purchased interest rate caps	114		114	

The Company s impaired loans and acquired assets are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using level 2 inputs based upon appraisals of similar properties obtained from a third party. For Level 3 input, collateral values are based on management s estimates pending appraisals from third party valuation services or imminent sale of collateral.

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Assets Measured At Fair Value On A Nonrecurring Basis

		Fair Value Measurements at Reporting Date Using:		
March 31, 2011:	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
		(Dollars in thousands)		
Impaired Loans	$ 2,772	$	$	$ 2,772
Acquired assets	805			805
Premises	362			362

		Fair Value Measurements at Reporting Date Using:		
June 30, 2010:	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
		(Dollars in thousands)		
Impaired Loans	$ 1,020	$	$	$ 1,020
Acquired assets	501			501
Premises	402			402

The following tables show the changes in the fair values of impaired loans measured on a nonrecurring basis using significant unobservable inputs (Level 3) for the nine months ended March 31, 2011 and 2010.

	2011	2010
	(Dollars in thousands)	
Beginning balance at July 1	$ 1,020	$ 1,196
Loans transferred in(out) of Level 3	1,752	(182)
Ending balance at March 31	$ 2,772	$ 1,014

The following table shows the changes in the fair value of acquired assets measured on a nonrecurring basis using significant unobservable inputs (Level 3) for the nine months ended March 31, 2011.

	2011
	(Dollars in thousands)
Beginning balance at July 1	$ 501
Loans transferred in Level 3	304
Ending balance at March 31	$ 805

The following table shows the changes in fair value of premises measured on a nonrecurring basis using significant unobservable inputs (Level 3) for the nine months ended March 31, 2011.

2011

		(Dollars in thousands)
Beginning balance at July 1	$	402
Premises transferred out Level 3		(40)
Ending balance at March 31	$	362

Liabilities Measured At Fair Value On A Recurring Basis

		Fair Value Measurements at Reporting Date Using:		
March 31, 2011:	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
		(Dollars in thousands)		
Derivative financial instruments	$ 321	$	$	$ 321

		Fair Value Measurements at Reporting Date Using:		
June 30, 2010:	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
		(Dollars in thousands)		
Derivative financial instruments	$ 413	$	$	$ 413

The following table shows the change in the fair value of derivative financial instruments measured on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended March 31, 2011.

	2011
	(Dollars in thousands)
Beginning balance at July 1	$ 413
Transferred out of Level 3	(92)
Ending balance at March 31	$ 321

The Company s derivative financial instruments are generally classified within level 3 of the fair value hierarchy. For these financial instruments, the Company obtains fair value measurements from independent pricing services. The fair value measurements utilize a discounted cash flow model that incorporates and considers observable data that may include publicly available third party market quotes, in developing the curve utilized for discounting future cash flows.

Fair value estimates, methods and assumptions are set forth below for the Company s significant financial instruments.

Cash and Cash Equivalents - The fair value of cash, due from banks, interest bearing deposits and FHLB overnight deposits approximates their relative book values, as these financial instruments have short maturities.

Available-for-sale Securities - The fair value of available-for-sale securities is estimated based on bid prices published in financial newspapers or bid quotations received from securities dealers.

Federal Home Loan Bank and Federal Reserve Stock - The carrying value of Federal Home Loan Bank stock and Federal Reserve stock approximates fair value based on redemption provisions of the Federal Home Loan Bank and the Federal Reserve.

Loans and Loans held-for-sale - Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimates of maturity are based on the Company s historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic conditions, lending conditions and the effects of estimated prepayments.

Fair value for significant nonperforming loans is based on estimated cash flows and is discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are developed using available market information and historical information.

Management has made estimates of fair value using discount rates that it believes to be reasonable. However, because there is no market for many of these financial instruments, management has no basis to determine whether the fair value presented would be indicative of the value negotiated in an actual sale.

The fair value of loans held-for-sale is estimated based on bid quotations received from loan dealers.

Interest Receivable - The fair value of this financial instrument approximates the book value as this financial instrument has a short maturity. It is the Company s policy to stop accruing interest on loans past due by more than ninety days. Therefore, this financial instrument has been adjusted for estimated credit loss.

Derivative financial instruments: Fair value for interest rate caps and interest rate swap agreements are based upon the amounts required to settle the contracts.

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Deposits - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW accounts and money market accounts, is equal to the amount payable on demand. The fair values of time deposits are based on the discounted value of contractual cash flows.

The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market. If that value was considered, the fair value of the Company s net assets could increase.

Borrowings - The fair value of the Company s borrowings with the FHLB is estimated by discounting the cash flows through maturity or the next repricing date based on current rates available to the Company for borrowings with similar maturities. The fair value of the Company s short-term borrowings, capital lease obligations, structured repurchase agreements and other borrowings is estimated by discounting the cash flows through maturity based on current rates available to the Company for borrowings with similar maturities.

Junior Subordinated Debentures - The fair value of the Junior Subordinated Debentures is estimated based on current interest rates.

Due-to-Broker - The fair value of due-to-broker approximates carrying value due to their short term nature.

Commitments to Originate Loans - The Company has not estimated the fair value of commitments to originate loans due to their short term nature and their relative immateriality.

Limitations - Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These values do not reflect any premium or discount that could result from offering for sale at one time the Company s entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature, involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial instruments include the deferred tax asset, premises and equipment and intangible assets, including the customer base. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

The following table presents the estimated fair value of the Company s significant financial instruments at March 31, 2011 and June 30, 2010:

	March 31, 2011		June 30, 2010	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
	(Dollars in Thousands)			
Financial assets:				
Cash and cash equivalents	$ 109,755	$ 109,755	$20,435	$ 20,435
Available-for-sale securities	127,227	127,227	164,188	164,188
Federal Home Loan Bank and Federal Reserve stock	5,486	5,486	5,486	5,486
Loans held-for-sale	8,378	8,378	14,254	14,289
Loans, net	313,042	312,681	376,503	387,008
Accrued interest receivable	1,375	1,375	2,081	2,081
Other assets purchased interest rate caps	99	99	114	114
Financial liabilities:				
Deposits (with no stated maturity)	187,859	187,859	179,846	179,846
Time deposits	213,505	214,505	204,351	209,756
Federal Home Loan Bank advances	43,974	43,974	50,500	53,907
Structured repurchase agreements	68,434	68,434	65,000	70,897

Other borrowings	2,134	2,134	2,630	2,801
Short-term borrowings	13,226	13,226	46,168	46,168
Capital lease obligation	2,114	2,114	2,231	2,481
Junior subordinated debentures issued to affiliated trusts	7,922	7,992	16,496	6,765
Other liabilities interest rate swaps	321	321	413	413

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13. Derivatives

The Company has stand alone derivative financial instruments in the form of interest rate caps which derive their value from a fee paid and are adjusted to fair value based on index and strike rate, and a swap agreement which derives its value from the underlying interest rate. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such differences, which represent the fair value of the derivative instruments, are reflected on the Company s balance sheet as derivative assets and derivative liabilities.

The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations. The Company deals only with primary dealers.

Derivative instruments are generally negotiated over-the-counter contracts. Negotiated over-the-counter derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

Risk Management Policies Hedging Instruments

The Company evaluates the effectiveness of entering into any derivative instrument agreement by measuring the cost of such an agreement in relation to the reduction in net income volatility within an assumed range of interest rates.

Interest Rate Risk Management Cash Flow Hedging Instruments

The Company uses long-term variable rate debt as a source of funds for use in the Company s lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore, generally hedges a portion of its variable-rate interest payments. To meet this objective, management enters into interest rate caps whereby the Company receives variable interest payments above a specified interest rate and swap agreements whereby the Company receives variable interest rate payments and makes fixed interest rate payments during the contract period.

At March 31, 2011, the information pertaining to outstanding interest rate caps and swap agreements used to hedge variable rate debt is as follows:

	Interest Rate Caps	Interest Rate Swap
Notional amount (Dollars in thousands)	$ 6,000	$ 10,000
Weighted average pay rate		4.69%
Weighted average receive rate		2.20%
Strike rate based on 3 month LIBOR	2.505%	
Weighted average maturity in years	3.50	3.92
Unrealized gains	5	95

The Company purchased two interest rate caps for $325,000, which expire September 30, 2014. The swap agreement provided for the Company to receive payments at a variable rate determined by a specified index (three month LIBOR) in exchange for making payments at a fixed rate.

During the three months ended March 31, 2011, no interest rate cap or swap agreements were terminated prior to maturity. At March 31, 2011, the unrealized loss relating to interest rate caps and swaps was recorded in derivative liabilities in

accordance with ASC 815, *Derivatives and Hedging Overview*. Changes in the fair value of interest rate caps and swaps designated as hedging instruments of the variability of cash flows associated with long-term debt are reported in other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the long-term debt affects earnings. None of the other comprehensive income was reclassified into interest expense during the three months ended March 31, 2011.

Risk management results for the three months ended March 31, 2011 related to the balance sheet hedging of long-term debt indicates that the hedges were 100% effective and that there was no component of the derivative instruments gain or loss which was excluded from the assessment of hedge effectiveness.

As of March 31, 2011, none of the losses reported in other comprehensive income related to the interest rate caps and swap agreements are expected to be reclassified into interest expense as a yield adjustment of the hedged borrowings during the three-months ended June 30, 2011.

March 31, 2011	Asset Derivatives	
Derivatives designated as hedging instruments under ASC 815:		
	Balance Sheet Location	Fair Value
	(Dollars in thousands)	
Interest Rate Caps	Other Assets	$ 99
Interest Rate Swaps	Other Liabilities	321

June 30, 2010	Asset Derivatives	
Derivatives designated as hedging instruments under ASC 815:		
	Balance Sheet Location	Fair Value
	(Dollars in thousands)	
Interest Rate Contracts	Other Assets	$ 114
Interest Rate Swaps	Other Liabilities	413

See Note 7, Structured Repurchase Agreements, for additional information on purchased interest rate caps.

14. Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued ASU 2010-06, *Improving Disclosures about Fair Value Measurements*. The ASU requires disclosing the amounts of significant transfers in and out of Level 1 and 2 of the fair value hierarchy and describing the reasons for the transfers. The disclosures became effective for reporting periods beginning after December 15, 2009. The Company adopted ASU 2010-06 as of January 1, 2010. Additionally, disclosures of the gross purchases, sales, issuances and settlements activity in the Level 3 of the fair value measurement hierarchy will be required for fiscal years beginning after December 15, 2010.

The Company did not have any significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy during the nine months ended March 31, 2011.

In March 2010, the FASB issued ASU 2010-11, *Scope Exception Related to Embedded Credit Derivatives*. The ASU clarifies that certain embedded derivatives, such as those contained in certain securitizations, CDOs and structured notes, should be considered embedded credit derivatives subject to potential bifurcation and separate fair value accounting. The ASU allows any beneficial interest issued by a securitization vehicle to be accounted for under the fair value option at transition. At transition, the Company may elect to reclassify various debt securities (on an instrument-by-instrument basis) from held-to-maturity or available-for-sale to trading. The new rules are effective July 1, 2010. This ASU did not have a significant impact on the Company s financial condition and results of operations.

In April 2010, the FASB issued ASU 2010-18, *Effect of a Loan Modification When the Loan is Part of a Pool that is accounted for as a Single Asset*. As a result of this ASU, modifications of loans that are accounted for within a pool under Subtopic 310-30 do not result in the removal of those loans from the pool even if the modification of those loans would otherwise be considered a troubled debt restructuring. An entity will continue to be required to consider whether the pool of assets in which the loan is included is impaired if expected cash flows for the pool change. The amendments in this ASU are effective for modifications of loans accounted for within pools under Subtopic 310-30 occurring in the first interim or annual period ended on or after July 15, 2010. The amendments are to be applied prospectively. Early application is permitted.

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In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. This ASU is created to provide financial statement users with greater transparency about an entity s allowance for credit losses and the credit quality of its financing receivables. This ASU is intended to provide additional information to assist financial statement users in assessing the entity s credit risk exposures and evaluating the adequacy of its allowance for credit losses. The amendments in this ASU are effective as of the end of a reporting period for interim and annual reporting periods ended on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010.

In December 2010, the FASB issued ASU 2010-28, *Intangibles - Goodwill and Other*. This ASU is to addresses when to perform step 2 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For public entities, the amendments in this ASU are effective for fiscal years, and interim periods beginning after December 15, 2010.

In December 2010, the FASB issued ASU 2010-29, *Disclosure of Supplementary Pro Forma Information for Business Combinations*. This ASU addresses diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations. This ASU is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010.

In April 2011, the FASB issued ASU 2011-02, A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring. This ASU provides additional guidance or clarification to help creditors determine whether a restructuring constitutes a troubled debt restructuring. For public entities, the amendments in this ASU are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired, and should measure impairment on those receivables prospectively for the first interim or annual period beginning on or after June 15, 2011. Additional disclosures are also required under this ASU. The Company is curr