

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, 2015

OR

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

For the transition period from _____ to _____

Commission file number 0-22345

SHORE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

52-1974638
(I.R.S. Employer
Identification No.)

28969 Information Lane, Easton, Maryland
(Address of Principal Executive Offices)

21601
(Zip Code)

(410) 763-7800
Registrant's Telephone Number, Including Area Code

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ 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 the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐
Non-accelerated filer ☐
(Do not check if a smaller reporting company)

Accelerated filer ☒
Smaller reporting company ☐

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 12,625,276 shares of common stock outstanding as of April 30, 2015.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

SHORE BANCSHARES, INC. CONSOLIDATED BALANCE SHEETS (Dollars in thousands, except per share amounts)

	March 31, 2015	December 31, 2014
	(Unaudited)	
ASSETS		
Cash and due from banks	\$ 24,319	\$ 24,211
Interest-bearing deposits with other banks	48,398	68,460
Federal funds sold	3,241	3,552
Investment securities:		
Available for sale, at fair value	240,111	236,108
Held to maturity, at amortized cost – fair value of \$4,616 (2015) and \$4,694 (2014)	4,515	4,630
Loans	721,605	710,746
Less: allowance for credit losses	(7,798)	(7,695)
Loans, net	713,807	703,051
Premises and equipment, net	16,728	16,275
Goodwill	11,931	11,931
Other intangible assets, net	1,297	1,331
Other real estate owned, net	3,469	3,691
Other assets	26,312	27,162
TOTAL ASSETS	\$ 1,094,128	\$ 1,100,402
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 201,518	\$ 193,814
Interest-bearing	739,256	755,190
Total deposits	940,774	949,004
Short-term borrowings	5,098	4,808
Other liabilities	5,510	6,121
TOTAL LIABILITIES	951,382	959,933
STOCKHOLDERS' EQUITY		
Common stock, par value \$.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 12,625,276 (2015) and 12,618,513 (2014)	126	126
Additional paid in capital	63,668	63,532
Retained earnings	77,904	76,495
Accumulated other comprehensive income	1,048	316
TOTAL STOCKHOLDERS' EQUITY	142,746	140,469
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 1,094,128	\$ 1,100,402

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(Dollars in thousands, except per share amounts)

	For the Three Months Ended March 31,	
	2015	2014
INTEREST INCOME		
Interest and fees on loans	\$ 8,491	\$ 8,875
Interest and dividends on investment securities:		
Taxable	924	521
Tax-exempt	3	3
Interest on federal funds sold	1	-
Interest on deposits with other banks	26	56
Total interest income	<u>9,445</u>	<u>9,455</u>
INTEREST EXPENSE		
Interest on deposits	901	1,127
Interest on short-term borrowings	5	5
Total interest expense	<u>906</u>	<u>1,132</u>
NET INTEREST INCOME	<u>8,539</u>	<u>8,323</u>
Provision for credit losses	650	975
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	<u>7,889</u>	<u>7,348</u>
NONINTEREST INCOME		
Service charges on deposit accounts	634	558
Trust and investment fee income	469	431
Insurance agency commissions	2,475	3,077
Other noninterest income	507	722
Total noninterest income	<u>4,085</u>	<u>4,788</u>
NONINTEREST EXPENSE		
Salaries and wages	4,313	4,314
Employee benefits	1,156	1,182
Occupancy expense	626	627
Furniture and equipment expense	255	273
Data processing	783	760
Directors' fees	123	112
Amortization of other intangible assets	33	74
Insurance agency commissions expense	-	512
FDIC insurance premium expense	384	458
Write-downs of other real estate owned	27	75
Other noninterest expenses	2,004	1,728
Total noninterest expense	<u>9,704</u>	<u>10,115</u>
INCOME BEFORE INCOME TAXES	<u>2,270</u>	<u>2,021</u>
Income tax expense	861	763
NET INCOME	<u>\$ 1,409</u>	<u>\$ 1,258</u>
Basic net income per common share	\$ 0.11	\$ 0.15
Diluted net income per common share	0.11	0.15
Dividends paid per common share	-	-

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended March 31,	
	2015	2014
Net income	\$ 1,409	\$ 1,258
Other comprehensive income		
Securities available for sale:		
Unrealized holding gains on available-for-sale securities	1,227	89
Tax effect	(495)	(36)
Net of tax amount	732	53
Total other comprehensive income	732	53
Comprehensive income	\$ 2,141	\$ 1,311

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Three Months Ended March 31, 2015 and 2014
(Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2015	\$ 126	\$ 63,532	\$ 76,495	\$ 316	\$ 140,469
Net income	-	-	1,409	-	1,409
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	732	732
Stock-based compensation	-	136	-	-	136
Balances, March 31, 2015	<u>\$ 126</u>	<u>\$ 63,668</u>	<u>\$ 77,904</u>	<u>\$ 1,048</u>	<u>\$ 142,746</u>
Balances, January 1, 2014	\$ 85	\$ 32,207	\$ 71,444	\$ (437)	\$ 103,299
Net income	-	-	1,258	-	1,258
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	53	53
Stock-based compensation	-	22	-	-	22
Balances, March 31, 2014	<u>\$ 85</u>	<u>\$ 32,229</u>	<u>\$ 72,702</u>	<u>\$ (384)</u>	<u>\$ 104,632</u>

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended March 31,	
	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 1,409	\$ 1,258
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	650	975
Depreciation and amortization	621	555
Discount accretion on debt securities	(18)	(12)
Stock-based compensation expense	136	22
Deferred income tax expense	618	699
Losses (gains) on sales of other real estate owned	48	(7)
Write-downs of other real estate owned	27	75
Net changes in:		
Accrued interest receivable	59	68
Other assets	(399)	156
Accrued interest payable	(17)	(3)
Other liabilities	(594)	154
Net cash provided by operating activities	<u>2,540</u>	<u>3,940</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of investment securities available for sale	8,697	16,811
Purchases of investment securities available for sale	(11,736)	(22,024)
Proceeds from maturities and principal payments of investment securities held to maturity	112	108
Net change in loans	(11,904)	9,162
Purchases of premises and equipment	(678)	(143)
Proceeds from sales of other real estate owned	644	48
Net cash (used in) provided by investing activities	<u>(14,865)</u>	<u>3,962</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net changes in:		
Noninterest-bearing deposits	7,704	(7,338)
Interest-bearing deposits	(15,934)	3,314
Short-term borrowings	290	(2,070)
Net cash used in financing activities	<u>(7,940)</u>	<u>(6,094)</u>
Net (decrease) increase in cash and cash equivalents	<u>(20,265)</u>	<u>1,808</u>
Cash and cash equivalents at beginning of period	96,223	131,090
Cash and cash equivalents at end of period	<u>\$ 75,958</u>	<u>\$ 132,898</u>
Supplemental cash flows information:		
Interest paid	\$ 923	\$ 1,136
Income taxes paid	\$ 95	\$ 2
Transfers from loans to other real estate owned	\$ 497	\$ 1,010
Transfers from loans held for sale to loans	\$ -	\$ 3,521

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.
Notes to Consolidated Financial Statements
For the Three Months Ended March 31, 2015 and 2014
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America (“GAAP”) and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at March 31, 2015, the consolidated results of operations and comprehensive income for the three months ended March 31, 2015 and 2014, and changes in stockholders’ equity and cash flows for the three months ended March 31, 2015 and 2014, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2014 were derived from the 2014 audited financial statements. The results of operations for the three months ended March 31, 2015 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2014. For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation .

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

Recent Accounting Standards

ASU 2014-04, “*Receivables (ASC Topic 310) – Troubled Debt Restructurings by Creditors, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.*” ASU 2014-04 clarifies when an in substance repossession or foreclosure occurs which is defined as when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU requires that the real property be recognized upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The Company adopted ASU No. 2014-04 effective January 1, 2015. The adoption of ASU No. 2014-04 did not have a material impact on the Company's Consolidated Financial Statements.

ASU No. 2014-14, “*Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure.*” ASU 2014-14 the FASB issued an amendment to clarify how creditors are to classify certain government-guaranteed mortgage loans upon foreclosure. This amendment requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separate from the loan before foreclosure and (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under the claim and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This amendment is effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2014. Entities may apply the amendments in this Update either (a) prospectively to foreclosures that occur after the date of adoption or (b) modified retrospective transition using a cumulative-effect adjustment (through a reclassification to a separate other receivable) as of the beginning of the annual period of adoption. Prior periods should not be adjusted. The Company adopted ASU No. 2014-14 effective January 1, 2015. The adoption of ASU No. 2014-14 did not have a material impact on the Company's Consolidated Financial Statements.

ASU No. 2015-02, “*Amendments to the Consolidation Analysis.*” This ASU affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. Specifically, the amendments: (1) Modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (“VIEs”) or voting interest entities; (2) Eliminate the presumption that a general partner should consolidate a limited partnership; (3) Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships; and (4) Provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. ASU No. 2015-02 is effective for interim and annual reporting periods beginning after December 15, 2015. The Company is currently evaluating the provisions of ASU No. 2015-02 to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements.

ASU No. 2015-05, “*Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement.*” This ASU provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The new guidance does not change the accounting for a customer’s accounting for service contracts. ASU No. 2015-05 is effective for interim and annual reporting periods beginning after December 15, 2015. The Company is currently evaluating the provisions of ASU No. 2015-05 to determine the potential impact the new standard will have on the Company’s Consolidated Financial Statements.

Note 2 – Earnings Per Share

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

(In thousands, except per share data)	For the Three Months Ended March 31,	
	2015	2014
Net income	<u>\$ 1,409</u>	<u>\$ 1,258</u>
Weighted average shares outstanding - Basic	<u>12,625</u>	<u>8,471</u>
Dilutive effect of common stock equivalents	<u>8</u>	<u>13</u>
Weighted average shares outstanding - Diluted	<u>12,633</u>	<u>8,484</u>
Earnings per common share - Basic	<u>\$ 0.11</u>	<u>\$ 0.15</u>
Earnings per common share - Diluted	<u>\$ 0.11</u>	<u>\$ 0.15</u>

The increase in the weighted average shares outstanding for the three months ended March 31, 2015 when compared to the three months ended March 31, 2014 was due to the Company’s public offer and sale of its common stock (the “stock sale”) during the second quarter of 2014. As a result of the stock sale, the Company sold 4,140,000 shares of its common stock for a price of \$8.25 per share, which produced net proceeds of \$31.3 million.

There were no weighted average common stock equivalents excluded from the calculation of diluted earnings per share for the three months ended March 31, 2015 and 2014.

Note 3 – Investment Securities

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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
March 31, 2015				
U.S. Treasury	\$ 5,178	\$ 14	\$ -	\$ 5,192
U.S. Government agencies	76,019	219	211	76,027
Mortgage-backed	156,530	2,000	277	158,253
Equity	627	12	-	639
Total	<u>\$ 238,354</u>	<u>\$ 2,245</u>	<u>\$ 488</u>	<u>\$ 240,111</u>
December 31, 2014				
U.S. Treasury	\$ 5,210	\$ 5	\$ -	\$ 5,215
U.S. Government agencies	75,220	87	347	74,960
Mortgage-backed	154,525	1,230	452	155,303
Equity	624	6	-	630
Total	<u>\$ 235,579</u>	<u>\$ 1,328</u>	<u>\$ 799</u>	<u>\$ 236,108</u>
Held-to-maturity securities:				
March 31, 2015				
U.S. Government agencies	\$ 2,677	\$ -	\$ 53	\$ 2,624
States and political subdivisions	1,838	154	-	1,992
Total	<u>\$ 4,515</u>	<u>\$ 154</u>	<u>\$ 53</u>	<u>\$ 4,616</u>
December 31, 2014				
U.S. Government agencies	\$ 2,791	\$ -	\$ 83	\$ 2,708
States and political subdivisions	1,839	147	-	1,986
Total	<u>\$ 4,630</u>	<u>\$ 147</u>	<u>\$ 83</u>	<u>\$ 4,694</u>

The following tables provide information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2015						
Available-for-sale securities:						
U.S. Government agencies	\$ 12,970	\$ 39	\$ 6,983	\$ 17	\$ 19,953	\$ 211
Mortgage-backed	5,969	22	25,638	410	31,607	277
Total	<u>\$ 18,939</u>	<u>\$ 61</u>	<u>\$ 33,261</u>	<u>\$ 427</u>	<u>\$ 52,200</u>	<u>\$ 488</u>
Held-to-maturity securities:						
U.S. Government agencies	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,624</u>	<u>\$ 53</u>	<u>\$ 2,624</u>	<u>\$ 53</u>

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2014						
Available-for-sale securities:						
U.S. Government agencies	\$ 41,574	\$ 138	\$ 6,954	\$ 209	\$ 48,528	\$ 347
Mortgage-backed	12,933	44	26,828	408	39,761	452
Total	<u>\$ 54,507</u>	<u>\$ 182</u>	<u>\$ 34,412</u>	<u>\$ 617</u>	<u>\$ 88,919</u>	<u>\$ 799</u>
Held-to-maturity securities:						
U.S. Government agencies	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,708</u>	<u>\$ 83</u>	<u>\$ 2,708</u>	<u>\$ 83</u>

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

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at March 31, 2015.

(Dollars in thousands)	Available for sale		Held to maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 2,001	\$ 2,004	\$ 221	\$ 222
Due after one year through five years	76,053	76,191	711	766
Due after five years through ten years	10,647	10,782	403	461
Due after ten years	149,026	150,495	3,180	3,167
	<u>237,727</u>	<u>239,472</u>	<u>4,515</u>	<u>4,616</u>
Equity securities	627	639	-	-
Total	<u>\$ 238,354</u>	<u>\$ 240,111</u>	<u>\$ 4,515</u>	<u>\$ 4,616</u>

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

Note 4 – Loans and Allowance for Credit Losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne's County, Kent County, Caroline County and Dorchester County in Maryland and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	March 31, 2015	December 31, 2014
Construction	\$ 77,697	\$ 69,157
Residential real estate	264,424	273,336
Commercial real estate	316,389	305,788
Commercial	55,079	52,671
Consumer	8,016	9,794
Total loans	<u>721,605</u>	<u>710,746</u>
Allowance for credit losses	<u>(7,798)</u>	<u>(7,695)</u>
Total loans, net	<u>\$ 713,807</u>	<u>\$ 703,051</u>

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

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the amount of impairment has been determined, the uncollectible portion is charged off. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses. See additional discussion under the caption "Critical Accounting Policies" in Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

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

The following tables include impairment information relating to loans and the allowance for credit losses as of March 31, 2015 and December 31, 2014.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
March 31, 2015							
Loans individually evaluated for impairment	\$ 12,601	\$ 7,975	\$ 8,761	\$ 99	\$ 123	\$ -	\$ 29,559
Loans collectively evaluated for impairment	65,096	256,449	307,628	54,980	7,893	-	692,046
Total loans	<u>\$ 77,697</u>	<u>\$ 264,424</u>	<u>\$ 316,389</u>	<u>\$ 55,079</u>	<u>\$ 8,016</u>	<u>\$ -</u>	<u>\$ 721,605</u>

Allowance for credit losses allocated to:

Loans individually evaluated for impairment	\$ 729	\$ 350	\$ 23	\$ -	\$ -	\$ -	\$ 1,102
Loans collectively evaluated for impairment	1,155	1,774	2,316	441	180	830	6,696
Total allowance for credit losses	<u>\$ 1,884</u>	<u>\$ 2,124</u>	<u>\$ 2,339</u>	<u>\$ 441</u>	<u>\$ 180</u>	<u>\$ 830</u>	<u>\$ 7,798</u>

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
December 31, 2014							
Loans individually evaluated for impairment	\$ 10,067	\$ 10,403	\$ 9,359	\$ 188	\$ 124	\$ -	\$ 30,141
Loans collectively evaluated for impairment	59,090	262,933	296,429	52,483	9,670	-	680,605
Total loans	<u>\$ 69,157</u>	<u>\$ 273,336</u>	<u>\$ 305,788</u>	<u>\$ 52,671</u>	<u>\$ 9,794</u>	<u>\$ -</u>	<u>\$ 710,746</u>

Allowance for credit losses allocated to:

Loans individually evaluated for impairment	\$ 41	\$ 1,099	\$ 129	\$ 1	\$ 3	\$ -	\$ 1,273
Loans collectively evaluated for impairment	1,262	1,735	2,250	447	226	502	6,422
Total allowance for credit losses	<u>\$ 1,303</u>	<u>\$ 2,834</u>	<u>\$ 2,379</u>	<u>\$ 448</u>	<u>\$ 229</u>	<u>\$ 502</u>	<u>\$ 7,695</u>

The following tables provide information on impaired loans and any related allowance by loan class as of March 31, 2015 and December 31, 2014. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken.

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to- date average recorded investment	Year-to-date average recorded investment
March 31, 2015						
Impaired nonaccrual loans:						
Construction	\$ 12,188	\$ 5,681	\$ 2,904	\$ 690	\$ 7,861	\$ 7,861
Residential real estate	2,178	1,557	95	95	2,276	2,276
Commercial real estate	3,994	2,500	-	-	2,689	2,689
Commercial	63	54	-	-	49	49
Consumer	129	123	-	-	123	123
Total	<u>18,552</u>	<u>9,915</u>	<u>2,999</u>	<u>785</u>	<u>12,998</u>	<u>12,998</u>
Impaired accruing TDRs:						
Construction	4,016	3,196	820	39	4,019	4,019
Residential real estate	6,322	659	5,663	255	6,338	6,338
Commercial real estate	6,261	4,754	1,507	23	6,272	6,272
Commercial	45	45	-	-	46	46
Consumer	-	-	-	-	-	-
Total	<u>16,644</u>	<u>8,654</u>	<u>7,990</u>	<u>317</u>	<u>16,675</u>	<u>16,675</u>
Total impaired loans:						
Construction	16,204	8,877	3,724	729	11,880	11,880
Residential real estate	8,500	2,217	5,758	350	8,614	8,614
Commercial real estate	10,255	7,254	1,507	23	8,961	8,961
Commercial	108	99	-	-	95	95
Consumer	129	123	-	-	123	123
Total	<u>\$ 35,196</u>	<u>\$ 18,570</u>	<u>\$ 10,989</u>	<u>\$ 1,102</u>	<u>\$ 29,673</u>	<u>\$ 29,673</u>

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to- date average recorded investment	Year-to-date average recorded investment
December 31, 2014						
Impaired nonaccrual loans:						
Construction	\$ 9,277	\$ 6,045	\$ -	\$ -	\$ 7,364	\$ 7,739
Residential real estate	4,664	1,053	2,982	799	2,681	3,322
Commercial real estate	4,703	2,842	280	100	2,455	3,889
Commercial	1,372	136	5	1	141	437
Consumer	129	99	25	3	124	79
Total	<u>20,145</u>	<u>10,175</u>	<u>3,292</u>	<u>903</u>	<u>12,765</u>	<u>15,466</u>
Impaired accruing TDRs:						
Construction	4,022	3,196	826	41	3,609	2,743
Residential real estate	6,368	668	5,700	300	12,401	15,123
Commercial real estate	6,237	4,774	1,463	29	6,342	6,574
Commercial	47	47	-	-	48	55
Consumer	-	-	-	-	-	-
Total	<u>16,674</u>	<u>8,685</u>	<u>7,989</u>	<u>370</u>	<u>22,400</u>	<u>24,495</u>
Total impaired loans:						
Construction	13,299	9,241	826	41	10,973	10,482
Residential real estate	11,032	1,721	8,682	1,099	15,082	18,445
Commercial real estate	10,940	7,616	1,743	129	8,797	10,463
Commercial	1,419	183	5	1	189	492
Consumer	129	99	25	3	124	79
Total	<u>\$ 36,819</u>	<u>\$ 18,860</u>	<u>\$ 11,281</u>	<u>\$ 1,273</u>	<u>\$ 35,165</u>	<u>\$ 39,961</u>

The following tables provide a roll-forward for troubled debt restructurings as of March 31, 2015 and March 31, 2014.

(Dollars in thousands)	1/1/15 TDR Balance	New TDRs	Disbursements (Payments)	Charge offs	Reclassification/ Transfers In/(Out)	Payoffs	3/31/15 TDR Balance	Related Allowance
For the three months ended 3/31/2015								
Accruing TDRs								
Construction	\$ 4,022	\$ -	\$ (6)	\$ -	\$ -	\$ -	\$ 4,016	\$ 39
Residential Real Estate	6,368	-	(46)	-	-	-	6,322	255
Commercial Real Estate	6,237	-	24	-	-	-	6,261	23
Commercial	47	-	(2)	-	-	-	45	-
Consumer	-	-	-	-	-	-	-	-
Total	<u>\$ 16,674</u>	<u>\$ -</u>	<u>\$ (30)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 16,644</u>	<u>\$ 317</u>
Nonaccrual TDRs								
Construction	\$ 3,321	\$ -	\$ (7)	\$ (363)	\$ 2,911	\$ -	\$ 5,862	\$ 690
Residential Real Estate	3,382	-	(9)	-	(2,911)	-	462	-
Commercial Real Estate	346	-	(2)	(40)	(238)	-	66	-
Commercial	-	-	-	-	-	-	-	-
Consumer	25	-	(1)	-	-	-	24	-
Total	<u>\$ 7,074</u>	<u>\$ -</u>	<u>\$ (19)</u>	<u>\$ (403)</u>	<u>\$ (238)</u>	<u>\$ -</u>	<u>\$ 6,414</u>	<u>\$ 690</u>
Total TDRs	<u>\$ 23,748</u>	<u>\$ -</u>	<u>\$ (49)</u>	<u>\$ (403)</u>	<u>\$ (238)</u>	<u>\$ -</u>	<u>\$ 23,058</u>	<u>\$ 1,007</u>
(Dollars in thousands)	1/1/14 TDR Balance	New TDRs	Disbursements (Payments)	Charge offs	Reclassification/ Transfers In/(Out)	Payoffs	3/31/14 TDR Balance	Related Allowance
For the three months ended 3/31/2014								
Accruing TDRs								
Construction	\$ 1,620	\$ -	\$ (314)	\$ -	\$ -	\$ -	\$ 1,306	\$ 1
Residential Real Estate	14,582	-	1,421	-	201	(158)	16,046	143
Commercial Real Estate	9,791	-	(25)	(549)	(201)	(1,097)	7,919	6
Commercial	95	-	(9)	-	-	(24)	62	9
Consumer	-	-	-	-	-	-	-	-
Total	<u>\$ 26,088</u>	<u>\$ -</u>	<u>\$ 1,073</u>	<u>\$ (549)</u>	<u>\$ -</u>	<u>\$ (1,279)</u>	<u>\$ 25,333</u>	<u>\$ 159</u>
Nonaccrual TDRs								
Construction	\$ 3,561	\$ -	\$ (2)	\$ (17)	\$ 760	\$ -	\$ 4,302	\$ -
Residential Real Estate	1,884	-	(20)	(70)	(760)	-	1,034	-
Commercial Real Estate	842	-	(72)	(65)	-	-	705	-
Commercial	-	-	-	-	-	-	-	-
Consumer	26	-	(1)	-	-	-	25	-
Total	<u>\$ 6,313</u>	<u>\$ -</u>	<u>\$ (95)</u>	<u>\$ (152)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 6,066</u>	<u>\$ -</u>
Total TDRs	<u>\$ 32,401</u>	<u>\$ -</u>	<u>\$ 978</u>	<u>\$ (701)</u>	<u>\$ -</u>	<u>\$ (1,279)</u>	<u>\$ 31,399</u>	<u>\$ 159</u>

No loans were modified and considered TDRs during the three months ended March 31, 2015 and March 31, 2014.

The following tables provide information on TDRs that defaulted during the three months ended March 31, 2015 and March 31, 2014. Generally, a loan is considered in default when principal or interest is past due 90 days or more.

(Dollars in thousands)	Number of contracts	Recorded investment	Related allowance
TDRs that subsequently defaulted:			
For the three months ended March 31, 2015			
Construction	-	\$ -	\$ -
Residential real estate	-	-	-
Commercial real estate	2	279	-
Commercial	-	-	-
Consumer	-	-	-
Total	<u>2</u>	<u>\$ 279</u>	<u>\$ -</u>

TDRs that subsequently defaulted:			
For the three months ended March 30, 2014			
Construction	-	\$ -	\$ -
Residential real estate	-	-	-
Commercial real estate	-	-	-
Commercial	-	-	-
Consumer	-	-	-
Total	<u>-</u>	<u>\$ -</u>	<u>\$ -</u>

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

The following tables provide information on loan risk ratings as of March 31, 2015 and December 31, 2014.

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Total
March 31, 2015					
Construction	\$ 60,330	\$ 3,472	\$ 13,895	\$ -	\$ 77,697
Residential real estate	245,964	7,646	10,790	24	264,424
Commercial real estate	286,695	20,047	9,647	-	316,389
Commercial	53,076	1,896	107	-	55,079
Consumer	7,852	41	123	-	8,016
Total	\$ 653,917	\$ 33,102	\$ 34,562	\$ 24	\$ 721,605

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Total
December 31, 2014					
Construction	\$ 52,241	\$ 5,643	\$ 11,273	\$ -	\$ 69,157
Residential real estate	252,643	6,675	14,018	-	273,336
Commercial real estate	275,573	20,040	10,175	-	305,788
Commercial	50,583	1,885	114	89	52,671
Consumer	9,658	13	123	-	9,794
Total	\$ 640,698	\$ 34,256	\$ 35,703	\$ 89	\$ 710,746

The following tables provide information on the aging of the loan portfolio as of March 31, 2015 and December 31, 2014.

(Dollars in thousands)	Accruing					Nonaccrual	Total
	Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due		
March 31, 2015							
Construction	\$ 68,844	\$ 268	\$ -	\$ -	\$ 268	\$ 8,585	\$ 77,697
Residential real estate	257,818	1,933	3,012	9	4,954	1,652	264,424
Commercial real estate	311,204	1,555	1,130	-	2,685	2,500	316,389
Commercial	54,798	70	157	-	227	54	55,079
Consumer	7,825	35	6	27	68	123	8,016
Total	\$ 700,489	\$ 3,861	\$ 4,305	\$ 36	\$ 8,202	\$ 12,914	\$ 721,605
Percent of total loans	<u>97.1%</u>	<u>0.5%</u>	<u>0.6%</u>	<u>-%</u>	<u>1.1%</u>	<u>1.8%</u>	

(Dollars in thousands)	Accruing					Nonaccrual	Total
	Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due		
December 31, 2014							
Construction	\$ 61,325	\$ 1,786	\$ -	\$ -	\$ 1,786	\$ 6,046	\$ 69,157
Residential real estate	263,165	3,351	2,702	83	6,136	4,035	273,336
Commercial real estate	301,695	459	513	-	972	3,121	305,788
Commercial	52,352	47	131	-	178	141	52,671
Consumer	9,619	11	37	4	52	123	9,794
Total	\$ 688,156	\$ 5,654	\$ 3,383	\$ 87	\$ 9,124	\$ 13,466	\$ 710,746
Percent of total loans	<u>96.8%</u>	<u>0.8%</u>	<u>0.5%</u>	<u>-%</u>	<u>1.3%</u>	<u>1.9%</u>	

Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three months ended March 31, 2015 and 2014. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended March 31, 2015							
Allowance for credit losses:							
Beginning balance	\$ 1,303	\$ 2,834	\$ 2,379	\$ 448	\$ 229	\$ 502	\$ 7,695
Charge-offs	(363)	(114)	(40)	(124)	(10)	-	(651)
Recoveries	3	23	13	47	18	-	104
Net charge-offs	(360)	(91)	(27)	(77)	8	-	(547)
Provision	941	(619)	(13)	70	(57)	328	650
Ending balance	<u>\$ 1,884</u>	<u>\$ 2,124</u>	<u>\$ 2,339</u>	<u>\$ 441</u>	<u>\$ 180</u>	<u>\$ 830</u>	<u>\$ 7,798</u>

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended March 31, 2014							
Allowance for credit losses:							
Beginning balance	\$ 1,960	\$ 3,854	\$ 3,029	\$ 1,266	\$ 243	\$ 373	\$ 10,725
Charge-offs	(17)	(672)	(90)	(842)	(127)	-	(1,748)
Recoveries	10	43	6	50	8	-	117
Net charge-offs	(7)	(629)	(84)	(792)	(119)	-	(1,631)
Provision	44	(1,139)	1,639	203	184	44	975
Ending balance	<u>\$ 1,997</u>	<u>\$ 2,086</u>	<u>\$ 4,584</u>	<u>\$ 677</u>	<u>\$ 308</u>	<u>\$ 417</u>	<u>\$ 10,069</u>

Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure totaled \$27 thousand as of March 31, 2015.

Note 5 – Other Assets

The Company had the following other assets at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	March 31, 2015	December 31, 2014
Nonmarketable investment securities	\$ 1,706	\$ 1,586
Accrued interest receivable	2,604	2,663
Deferred income taxes	14,631	15,744
Prepaid expenses	1,615	750
Other assets	5,756	6,419
Total	<u>\$ 26,312</u>	<u>\$ 27,162</u>

The following table provides information on significant components of the Company's deferred tax assets and liabilities as of March 31, 2015 and December 31, 2014.

(Dollars in thousands)	March 31, 2015	December 31, 2014
Deferred tax assets:		
Allowance for credit losses	\$ 3,110	\$ 3,072
Reserve for off-balance sheet commitments	122	121
Net operating loss carry forward	12,516	13,265
Write-downs of other real estate owned	303	355
Deferred income	1,077	1,132
Accrued expenses	929	918
Other	174	80
Total deferred tax assets	<u>18,231</u>	<u>18,943</u>
Deferred tax liabilities:		
Depreciation	343	372
Purchase accounting adjustments	1,807	1,751
Deferred capital gain on branch sale	421	425
Unrealized gains on available-for-sale securities	709	214
Other	320	437
Total deferred tax liabilities	<u>3,600</u>	<u>3,199</u>
Net deferred tax assets	<u>\$ 14,631</u>	<u>\$ 15,744</u>

The Company's deferred tax assets primarily consist of net operating loss carryovers that will be used to offset taxable income in future periods through their statutory period of 20 years for federal tax purposes. No valuation allowance on these deferred tax assets was recorded at March 31, 2015 and December 31, 2014 as management believes it is more likely than not that all deferred tax assets will be realized based on the following positive material factors: 1) The Company was profitable for all four quarters of 2014 and the first quarter of 2015 on a GAAP basis. The net operating loss was originally created in the third quarter of 2013 and was solely attributable to an Asset Sale which is considered non-recurring. 2) The Company had pre-tax income of \$8.1 million for the year ended December 31, 2014, providing further evidence that the Asset Sale was producing positive results and confirming the expectation of utilizing the deferred tax assets. 3) As a contingent opportunity, the Company has had discussions with certain investors about entering into a sales leaseback transaction for some of its branch locations which would generate a material taxable gain. The decision to act on this has been deferred; however, it would become a very viable option as a tax planning strategy if there was a risk that the net operating loss carryovers would expire before they were fully utilized. Alternatively, the Company has reviewed negative factors which would influence the conclusion of realizing the deferred tax assets. These factors include the following: 1) The Company could be subject to Section 382 of the Internal Revenue Code ("IRC"), which could further limit the realization of the net operating loss-related deferred tax asset ("NOL-DTA"). 2) Although the local economy of the market in which the Company operates has been showing continued signs of improvement over the past three years, if this trend flattens or reverses, there is a potential that this potential negative evidence could outweigh the prevailing positive factors.

Based on the aforementioned considerations, the Company has concluded that the predominance of observable positive evidence outweighs the future potential of negative evidence and therefore it is more likely than not that the Company will be able to realize in the future all of the net deferred tax assets.

Note 6 – Other Liabilities

The Company had the following other liabilities at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	March 31, 2015	December 31, 2014
Accrued interest payable	\$ 155	\$ 172
Other accounts payable	1,900	2,435
Deferred compensation liability	1,520	1,503
Other liabilities	1,935	2,011
Total	<u>\$ 5,510</u>	<u>\$ 6,121</u>

Note 7 - Stock-Based Compensation

As of March 31, 2015, the Company maintained the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (“2006 Equity Plan”) under which it may issue shares of common stock or grant other equity-based awards. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date over a three- to five-year period of time, and, in the case of stock options, expire 7 years from the grant date. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant-date fair value and reflects forfeitures as they occur.

The following tables provide information on stock-based compensation expense for the first three months of 2015 and 2014.

(Dollars in thousands)	For the Three Months Ended March 31,	
	2015	2014
Stock-based compensation expense	\$ 136	\$ 22
Excess tax expense related to stock-based compensation	-	-

(Dollars in thousands)	March 31,	
	2015	2014
Unrecognized stock-based compensation expense	\$ 102	\$ 114
Weighted average period unrecognized expense is expected to be recognized	0.8 years	1.5 years

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the three months ended March 31, 2015 and 2014.

	Number of Shares	Weighted Average Grant Date Fair Value
March 31, 2015		
Nonvested at beginning of period	14,251	\$ 8.33
Granted	6,763	9.18
Vested	(8,680)	8.55
Cancelled	-	-
Nonvested at end of period	<u>12,334</u>	<u>\$ 8.22</u>

	Number of Shares	Weighted Average Grant Date Fair Value
March 31, 2014		
Nonvested at beginning of period	13,930	\$ 8.33
Granted	-	-
Vested	(3,333)	8.93
Cancelled	-	-
Nonvested at end of period	<u>10,597</u>	<u>\$ 8.14</u>

The fair value of restricted stock awards that vested during the first three months of 2015 was \$74 thousand.

The following table summarizes stock option activity for the Company under the 2006 Equity Plan for the three months ended March 31, 2015 and 2014.

March 31, 2015	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of period	27,108	\$ 6.64
Granted	34,219	3.44
Exercised	-	-
Expired/Cancelled	-	-
Outstanding at end of period	<u>61,327</u>	<u>\$ 4.85</u>
Exercisable at end of period	<u>27,108</u>	<u>\$ 6.64</u>
March 31, 2014	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of period	40,662	\$ 6.64
Granted	-	-
Exercised	-	-
Expired/Cancelled	-	-
Outstanding at end of period	<u>40,662</u>	<u>\$ 6.64</u>
Exercisable at end of period	<u>20,331</u>	<u>\$ 6.64</u>

At the end of the first quarter of 2015, the aggregate intrinsic value of the options outstanding under the 2006 Equity Plan was \$265 thousand based on the \$9.18 market value per share of the Company's common stock at March 31, 2015. Similarly, the aggregate intrinsic value of the options exercisable was \$69 thousand at March 31, 2015. Since there were no options exercised during the first three months of 2015 or 2014, there was no intrinsic value associated with stock options exercised and no cash received on exercise of options. At March 31, 2015, the weighted average remaining contract life of options outstanding was 7 years.

Note 8 – Accumulated Other Comprehensive Income

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for the three months ended March 31, 2015 and 2014.

(Dollars in thousands)	Accumulated net unrealized holding gains (losses) on available for sale securities	Total accumulated other comprehensive income (loss)
Balance, December 31, 2014	\$ 316	\$ 316
Other comprehensive income	732	732
Balance, March 31, 2015	<u>\$ 1,048</u>	<u>\$ 1,048</u>
Balance, December 31, 2013	\$ (437)	\$ (437)
Other comprehensive income	53	53
Balance, March 31, 2014	<u>\$ (384)</u>	<u>\$ (384)</u>

Note 9 – Fair Value Measurements

Accounting guidance under GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This accounting guidance also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

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

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

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

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

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

Investment Securities Available for Sale

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

The tables below present the recorded amount of assets measured at fair value on a recurring basis at March 31, 2015 and December 31, 2014. No assets were transferred from one hierarchy level to another during the first three months of 2015 or 2014.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
March 31, 2015				
Securities available for sale:				
U.S. Treasury	\$ 5,192	\$ 5,192	\$ -	\$ -
U.S. Government agencies	76,027	-	76,027	-
Mortgage-backed	158,253	-	158,253	-
Equity	639	-	639	-
Total	<u>\$ 240,111</u>	<u>\$ 5,192</u>	<u>\$ 234,919</u>	<u>\$ -</u>

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2014				
Securities available for sale:				
U.S. Treasury	\$ 5,215	\$ 5,215	\$ -	\$ -
U.S. Government agencies	74,960	-	74,960	-
Mortgage-backed	155,303	-	155,303	-
Equity	630	-	630	-
Total	<u>\$ 236,108</u>	<u>\$ 5,215</u>	<u>\$ 230,893</u>	<u>\$ -</u>

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

Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with contractual terms. The fair value of impaired loans can be estimated using one of several methods, including the collateral value, market value of similar debt, liquidation value and discounted cash flows. At March 31, 2015 and December 31, 2014, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 2 in the fair value hierarchy.

Loans held for sale

Loans held for sale are adjusted for fair value upon transfer of loans to loans held for sale. Subsequently, loans held for sale are carried at the lower of carrying value or fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At March 31, 2015 and December 31, 2014, the Company had no loans held for sale.

Other Real Estate and Other Assets Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value less estimated costs to sell. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At March 31, 2015 and December 31, 2014, foreclosed assets were classified as Level 2 in the fair value hierarchy.

The tables below present the recorded amount of assets measured at fair value on a nonrecurring basis at March 31, 2015 and December 31, 2014. No assets were transferred from one hierarchy level to another during the first three months of 2015 or 2014.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
March 31, 2015				
Impaired loans				
Construction	\$ 11,872	\$ -	\$ 11,872	\$ -
Residential real estate	7,624	-	7,624	-
Commercial real estate	8,738	-	8,738	-
Commercial	99	-	99	-
Consumer	123	-	123	-
Total impaired loans	28,456	-	28,456	-
Loans held for sale	-	-	-	-
Other real estate owned	3,469	-	3,469	-
Total assets measured at fair value on a nonrecurring basis	\$ 31,925	\$ -	\$ 31,925	\$ -

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2014				
Impaired loans				
Construction	\$ 10,026	\$ -	\$ 10,026	\$ -
Residential real estate	9,304	-	9,304	-
Commercial real estate	9,230	-	9,230	-
Commercial	187	-	187	-
Consumer	121	-	121	-
Total impaired loans	28,868	-	28,868	-
Loans held for sale	-	-	-	-
Other real estate owned	3,691	-	3,691	-
Total assets measured at fair value on a nonrecurring basis	\$ 32,559	\$ -	\$ 32,559	\$ -

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

Cash and Cash Equivalents

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

Investment Securities Held to Maturity

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

Loans

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

Financial Liabilities

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

Commitments to Extend Credit and Standby Letters of Credit

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

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

(Dollars in thousands)	March 31, 2015		December 31, 2014	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 1 inputs				
Cash and cash equivalents	\$ 75,958	\$ 75,958	\$ 96,223	\$ 96,223
Level 2 inputs				
Investment securities held to maturity	\$ 4,515	\$ 4,616	\$ 4,630	\$ 4,694
Loans, net	713,807	735,287	703,051	724,771
Financial liabilities				
Level 2 inputs				
Deposits	\$ 940,774	\$ 940,484	\$ 949,004	\$ 948,605
Short-term borrowings	5,098	5,098	4,808	4,808

Note 10 – Financial Instruments with Off-Balance Sheet Risk

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

The following table provides information on commitments outstanding at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	March 31, 2015	December 31, 2014
Commitments to extend credit	\$ 142,084	\$ 127,080
Letters of credit	7,155	7,347
Total	<u>\$ 149,239</u>	<u>\$ 134,427</u>

Note 11 – Segment Reporting

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

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

The following table includes selected financial information by business segments for the first three months of 2015 and 2014.

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
2015				
Interest income	\$ 9,394	\$ -	\$ 51	\$ 9,445
Interest expense	(906)	-	-	(906)
Provision for credit losses	(650)	-	-	(650)
Noninterest income	1,666	2,419	-	4,085
Noninterest expense	(5,527)	(1,751)	(2,426)	(9,704)
Net intersegment (expense) income	(1,993)	(197)	2,190	-
Income (loss) before taxes	1,984	471	(185)	2,270
Income tax (expense) benefit	(752)	(179)	70	(861)
Net income (loss)	<u>\$ 1,232</u>	<u>\$ 292</u>	<u>\$ (115)</u>	<u>\$ 1,409</u>
Total assets	<u>\$ 1,068,367</u>	<u>\$ 10,023</u>	<u>\$ 15,738</u>	<u>\$ 1,094,128</u>
2014				
Interest income	\$ 9,455	\$ -	\$ -	\$ 9,455
Interest expense	(1,132)	-	-	(1,132)
Provision for credit losses	(975)	-	-	(975)
Noninterest income	1,522	3,266	-	4,788
Noninterest expense	(5,591)	(2,615)	(1,909)	(10,115)
Net intersegment (expense) income	(1,662)	(181)	1,843	-
Income (loss) before taxes	1,617	470	(66)	2,021
Income tax (expense) benefit	(610)	(178)	25	(763)
Net income (loss)	<u>\$ 1,007</u>	<u>\$ 292</u>	<u>\$ (41)</u>	<u>\$ 1,258</u>
Total assets	<u>\$ 1,031,855</u>	<u>\$ 13,567</u>	<u>\$ 4,092</u>	<u>\$ 1,049,514</u>

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

Forward-Looking Information

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions about our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission (the "SEC") entitled "Risk Factors" (see Item 1A of Part II of this report and Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2014). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

Introduction

The following discussion and analysis is intended as a review of significant factors affecting the Company's financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented elsewhere in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2014.

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

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

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

Regulatory Enforcement Actions

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

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

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

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

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

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

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

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

Capital Requirements. Within 90 days from the effective date of the Order, Talbot Bank was required to meet and maintain the following minimum capital levels, after establishing an appropriate ALLL, (i) a leverage ratio (the ratio of Tier 1 capital to total assets) of at least 8%, and (ii) a total risk-based capital ratio (the ratio of qualifying total capital to risk-weighted assets) of at least 12%. As of March 31, 2015, the leverage ratio and total risk-based capital ratio were 9.36% and 13.96%, respectively, for Talbot Bank, which exceeded the Order’s minimum capital requirements.

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

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

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

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

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

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

Critical Accounting Policies

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

Allowance for Credit Losses

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

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

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

Subsequent Restructuring of Troubled Debt Restructuring (TDR) for Call Reporting

The Federal Financial Institutions Examinations Council (FFIEC) released Supplemental Instructions to the Call Report as of September 30, 2014. Included with these Supplemental Instructions was a section regarding Accounting for a Subsequent Restructuring of a Troubled Debt Restructuring (TDR). These new instructions allow for certain identified loans within our portfolio to be excluded from TDR designation for Call Report purposes if the borrower is no longer experiencing financial difficulties, the restructured loan is performing under a market rate of interest at the time of restructuring and no concession has been made on the principal balance of the loan. TDR classification within the accompanying financial statements herein are required to follow GAAP which follow their own separate set of standards when identifying and designating TDR status to any particular loan. The loans removed from TDR status for regulatory purposes were \$2.4 million in our Banks' call reports for the period ended March 31, 2015. The Company distinguishes the differences in reporting for TDRs and informs readers of the financial statements that certain outside data derived from external Call Reports can vary from the information found herein.

Goodwill and Other Intangible Assets

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

Deferred Tax Assets

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

Fair Value

The Company measures certain financial assets and liabilities at fair value. Investment securities are significant financial assets measured at fair value on a recurring basis. Impaired loans and other real estate owned are significant financial assets measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity.

OVERVIEW

The Company reported net income of \$1.4 million for the first quarter of 2015, or diluted income per common share of \$0.11, compared to net income of \$1.3 million, or diluted income per common share of \$0.15, for the first quarter of 2014. For the fourth quarter of 2014, the Company reported net income of \$1.2 million, or diluted income per common share of \$0.10. When comparing the first quarter of 2015 to the first quarter of 2014, the primary reasons for improved net income were increases in net interest income of \$216 thousand and a decline in the provision for credit losses of \$325 thousand. When comparing the first quarter of 2015 to the fourth quarter of 2014, the primary reason net income increased was a \$614 thousand increase in noninterest income partially offset by a decrease in net interest income of \$97 thousand and an increase in noninterest expense of \$194 thousand.

RESULTS OF OPERATIONS

Net Interest Income

Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income was \$8.6 million for the first quarter of 2015 and \$8.3 million for the first quarter of 2014. Tax-equivalent net interest income was \$8.6 million for the fourth quarter of 2014. The increase in net interest income for the first quarter of 2015 when compared to the first quarter of 2014 was primarily due to higher volumes of investment securities as well as a lower cost of deposits, partially offset by lower rates paid on loans. The decrease in net interest income for the first quarter of 2015 when compared to the fourth quarter of 2014 was primarily due to the downward re-pricing of loans which occurred in the first quarter of 2015. The lower yields were partially offset by an increase in volume of loans and investments and with lower volumes of and rates paid on time deposits. Net interest margin is tax-equivalent net interest income (annualized) divided by average earning assets. Our net interest margin was 3.43% for the first quarter of 2015, compared to 3.49% for the first quarter of 2014 and 3.35% for the fourth quarter of 2014. The lower net interest margin for the first quarter of 2015 when compared to the first quarter of 2014 was mainly due to lower yields earned on loans, partially offset by higher volumes on loans and investments and lower volumes of and rates paid on time deposits.

On a tax-equivalent basis, interest income decreased \$13 thousand, or 0.1%, for the first quarter of 2015 when compared to the first quarter of 2014. The decrease in interest income was primarily due to the decrease in yields earned on loans from 5.08% to 4.83%, offset by an increase in the average balance on loans of \$4.6 million. The decrease in interest income from loans was almost entirely offset by an increase in interest on taxable securities of \$403 thousand, or 77.4%, and the yield earned on these securities increasing from 1.34% to 1.52%. Although the average balances of the remaining components of average earning assets (i.e., tax-exempt securities, federal funds sold and interest bearing deposits with other banks) decreased \$46.2 million, the yields earned declined 5 basis points, which in aggregate decreased interest income \$29 thousand. Tax-equivalent interest income decreased \$180 thousand, or 1.9%, when compared to the fourth quarter of 2014 mainly due to lower yields earned on loans and lower volumes on interest bearing deposits with other banks, which were partially offset by higher volumes on taxable investment securities.

Interest expense decreased \$226 thousand, or 20.0%, when comparing the first quarter of 2015 to the first quarter of 2014. The decrease in interest expense was due to an 11 basis point decline in rates paid on interest-bearing liabilities (i.e., deposits and borrowings) and a 3.0% decline in average balances of interest-bearing liabilities. Changes in the rates and balances related to time deposits (i.e., certificates of deposit \$100,000 or more and other time deposits) had the largest impact on interest expense. For the three months ended March 31, 2015, the rates paid on time deposits decreased 16 basis points and the average balances of these deposits decreased \$40 million, or 11%, when compared to the same period last year, which reduced interest expense \$236 thousand. A portion of this decline was offset by increases in demand and money market deposits. Noninterest bearing deposits increased \$30.3 million when compared to the same period last year providing a lower cost of funding. When comparing the first quarter of 2015 to the fourth quarter of 2014, interest expense decreased \$82 thousand, or 8.3%. The decline was primarily due to lower interest rates paid on and average balances of time deposits.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended March 31, 2015 and 2014.

(Dollars in thousands)	For the Three Months Ended March 31, 2015			For the Three Months Ended March 31, 2014		
	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	\$ 714,780	\$ 8,510	4.83%	\$ 710,133	\$ 8,897	5.08%
Investment securities:						
Taxable	243,869	924	1.52	155,123	521	1.34
Tax-exempt	431	5	4.19	433	5	4.19
Federal funds sold	2,801	1	0.09	1,708	-	0.05
Interest-bearing deposits	51,609	26	0.20	98,907	56	0.23
Total earning assets	1,013,490	9,466	3.79%	966,304	9,479	3.97%
Cash and due from banks	21,268			22,708		
Other assets	60,611			66,203		
Allowance for credit losses	(7,968)			(10,647)		
Total assets	<u>\$ 1,087,401</u>			<u>\$ 1,044,568</u>		
Interest-bearing liabilities						
Demand deposits	\$ 177,071	57	0.13%	\$ 173,801	62	0.14%
Money market and savings deposits	237,755	82	0.14	222,378	67	0.12
Certificates of deposit \$100,000 or more	156,154	386	1.00	178,792	500	1.13
Other time deposits	169,584	376	0.90	186,960	498	1.08
Interest-bearing deposits	740,564	901	0.49	761,931	1,127	0.60
Short-term borrowings	7,340	5	0.27	9,345	5	0.22
Total interest-bearing liabilities	747,904	906	0.49%	771,276	1,132	0.60%
Noninterest-bearing deposits	191,896			161,593		
Other liabilities	5,717			7,237		
Stockholders' equity	141,884			104,462		
Total liabilities and stockholders' equity	<u>\$ 1,087,401</u>			<u>\$ 1,044,568</u>		
Net interest spread		<u>\$ 8,560</u>	3.30%		<u>\$ 8,347</u>	3.37%
Net interest margin			3.43%			3.49%
Tax-equivalent adjustment						
Loans		\$ 19			\$ 22	
Investment securities		2			2	
Total		<u>\$ 21</u>			<u>\$ 24</u>	

- (1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0%, exclusive of the alternative minimum tax rate and nondeductible interest expense.
- (2) Average loan balances include nonaccrual loans and loans held for sale.
- (3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

Noninterest Income

Total noninterest income for the first quarter of 2015 decreased \$703 thousand, or 14.7%, when compared to the first quarter of 2014. The decrease from the first quarter of 2014 was due to the loss of wholesale commission fees of \$1.2 million resulting from the sale of Tri-State General Insurance Agency, LTD ("Tri-State") in the second quarter of 2014 which was partially offset by an increase in retail insurance commissions of \$418 thousand and service charges on deposit accounts and trust and investment fee income of \$114 thousand in the aggregate. Noninterest income increased \$614 thousand when compared to the fourth quarter of 2014 mainly due to higher insurance agency commissions from contingency payments which are typically received in the first quarter of each year based on the prior year's performance.

Noninterest Expense

Total noninterest expense for the first quarter of 2015 decreased \$411 thousand, or 4.1%, when compared to the first quarter of 2014 and increased \$194 thousand, or 2.0%, when compared to the fourth quarter of 2014. The primary reason for the decrease in total noninterest expense from the first quarter of 2014 was the sale of Tri-State which reduced insurance agency commission expense and general operating expenses by \$1.1 million, offset by an increase in other noninterest expenses of \$276 thousand which was primarily the result of increased professional fees and marketing expenses. The increase from the fourth quarter of 2014 was primarily due to higher costs associated with employee benefits of

\$200 thousand, which included higher insurance premiums for group insurance and first quarter employer taxes.

Income Taxes

For the first quarter of 2015 and 2014, the Company reported income tax expense of \$861 thousand and \$763 thousand, respectively, while the effective tax rate was 37.9% and 37.8%, respectively. The relatively flat tax rates for the first quarter of 2015 when compared to the same period in 2014 were due to the consistent levels of pretax income and losses of the Company's affiliates which are offset to report a consolidated tax return.

The Company has net operating loss carryforwards ("NOLs") for federal and state income tax purposes that can be utilized to offset future taxable income. The Company's use of the NOLs would be limited, however, under Section 382 of the Internal Revenue Code ("IRC"), if the Company were to undergo a change in ownership of more than 50% of its capital stock over a three-year period as measured under Section 382 of the IRC. These complex changes of ownership rules generally focus on ownership changes involving shareholders owning directly or indirectly 5% or more of the Company's stock, including certain public "groups" of shareholders as set forth under Section 382 of the IRC, including those arising from new stock issuances and other equity transactions. Due to the stock sale in June, 2014 and other ownership changes by shareholders owning 5% or more of the Company's stock, the Company estimates that it has experienced an ownership change of approximately 44% for the three-year period ended March 31, 2015. The Company intends to take all action within its control to prevent a change in ownership in excess of 50% over any three-year testing period. For a further discussion of Section 382 and the potential impact on the Company, see "Part II – Item 1A. Risk Factors" herein.

ANALYSIS OF FINANCIAL CONDITION

Loans

Loans totaled \$721.6 million at March 31, 2015 and \$710.7 million at December 31, 2014, an increase of \$10.9 million, or 1.5%. Commercial real estate loans reflected the largest increase of \$10.6 million from the end of 2014. In addition, construction loans increased \$8.5 million these increases were partially offset by decreases in residential real estate loans of \$8.9 million and consumer loans of \$1.8 million. Loans included deferred costs, net of deferred fees, of \$535 thousand at March 31, 2015 and \$380 thousand at December 31, 2014. We do not engage in foreign or subprime lending activities. See Note 4, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements and below under the caption "Allowance for Credit Losses" for additional information.

Our loan portfolio has a commercial real estate loan concentration, which is defined as a combination of construction and commercial real estate loans. Construction loans were \$77.7 million, or 10.8% of total loans, at March 31, 2015, slightly higher than the \$69.1 million, or 9.7% of total loans at December 31, 2014. Commercial real estate loans were \$316.4 million, or 43.8% of total loans, at March 31, 2015, compared to \$305.8 million, or 43.0% of total loans at December 31, 2014.

Allowance for Credit Losses

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

The provision for credit losses was \$650 thousand for the first quarter of 2015, \$975 thousand for the first quarter of 2014 and \$650 thousand for the fourth quarter of 2014. The lower level of provision for credit losses when comparing the first quarter of 2015 to the first quarter of 2014 was primarily due to decreases in loan charge-offs and nonaccrual loans. The provision for credit losses when comparing the first quarter of 2015 to the fourth quarter of 2014 remained stable, although the amount of charge-offs decreased \$1 million and the gross amount of loans increased \$10.9 million between the comparable quarters. Net charge-offs were \$546 thousand for the first quarter of 2015 and \$1.6 million for both the first and fourth quarters of 2014. Management remains focused on its efforts to dispose of problem loans and to prudently charge-off nonperforming assets to enable the Company to continue to improve its overall credit quality and reduce problem loans. The allowance for credit losses as a percentage of period-end loans was 1.08% as of March 31, 2015 and 2014, improving from 1.43% as of December 31, 2014, which reflects improved credit quality in the loan portfolio. Management believes that the provision for credit losses and the resulting allowance were adequate to provide for probable losses inherent in our loan portfolio at March 31, 2015.

The following table presents a summary of the activity in the allowance for credit losses for the three months ended March 31, 2015 and 2014.

(Dollars in thousands)	For the Three Months Ended March 31,	
	2015	2014
Allowance balance – beginning of period	\$ 7,695	\$ 10,725
Charge-offs:		
Construction	(363)	(17)
Residential real estate	(114)	(672)
Commercial real estate	(40)	(90)
Commercial	(124)	(842)
Consumer	(10)	(127)
Totals	(651)	(1,748)
Recoveries:		
Construction	3	10
Residential real estate	23	43
Commercial real estate	13	6
Commercial	47	50
Consumer	18	8
Totals	104	117
Net charge-offs	(547)	(1,631)
Provision for credit losses	650	975
Allowance balance – end of period	\$ 7,798	\$ 10,069
Average loans outstanding during the period (1)	\$ 714,780	\$ 707,708
Net charge-offs (annualized) as a percentage of average loans outstanding during the period	0.31%	0.93%
Allowance for credit losses at period end as a percentage of average loans	1.08%	1.42%

(1) Excluding loans held for sale

Nonperforming Assets and Accruing TDRs

As shown in the following table, nonperforming assets decreased to \$16.4 million at March 31, 2015 from \$17.2 million at December 31, 2014, primarily due to a \$551 thousand decline in nonaccrual loans and a decrease in other real estate owned of \$222 thousand. In addition, accruing TDRs declined \$30 thousand to \$16.6 million at March 31, 2015 from \$16.7 million at December 31, 2014. The ratio of nonaccrual loans to total assets improved to 1.18% at March 31, 2015 from 1.22% at December 31, 2014.

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

The following table summarizes our nonperforming assets and accruing TDRs at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	March 31, 2015	December 31, 2014
Nonperforming assets		
Nonaccrual loans		
Construction	\$ 8,585	\$ 6,046
Residential real estate	1,652	4,035
Commercial real estate	2,500	3,121
Commercial	54	141
Consumer	123	123
Total nonaccrual loans	12,914	13,466
Loans 90 days or more past due and still accruing		
Construction	-	-
Residential real estate	9	83
Commercial real estate	-	-
Commercial	-	-
Consumer	27	4
Total loans 90 days or more past due and still accruing	36	87
Other real estate owned	3,469	3,691
Total nonperforming assets	\$ 16,420	\$ 17,245
Accruing TDRs		
Construction	\$ 4,016	\$ 4,022
Residential real estate	6,322	6,368
Commercial real estate	6,261	6,237
Commercial	45	47
Consumer	-	-
Total accruing TDRs	\$ 16,644	\$ 16,674
Total nonperforming assets and accruing TDRs	\$ 33,064	\$ 33,919
As a percent of total loans:		
Nonaccrual loans	1.79%	1.89%
Accruing TDRs	2.31%	2.35%
Nonaccrual loans and accruing TDRs	4.10%	4.24%
As a percent of total loans and other real estate owned:		
Nonperforming assets	2.26%	2.41%
Nonperforming assets and accruing TDRs	4.56%	4.75%
As a percent of total assets:		
Nonaccrual loans	1.18%	1.22%
Nonperforming assets	1.50%	1.57%
Accruing TDRs	1.52%	1.52%
Nonperforming assets and accruing TDRs	3.02%	3.08%

Investment Securities

The investment portfolio is comprised of securities that are either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent securities which may be sold as part of the asset/liability management strategy or in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At March 31, 2015, 98% of the portfolio was classified as available for sale and 2% as held to maturity, similar to the 98% and 2%, respectively, at December 31, 2014. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale. See Note 3 - Investment Securities, in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities totaled \$244.6 million at March 31, 2015, a \$3.9 million, or 0.02%, increase since December 31, 2014. The slight increase was due to purchases of mortgage-backed securities during the first quarter of 2015. At the end of March 2015, 65.9% of the securities available for sale were mortgage-backed, 31.7% were U.S. Government agencies and 2.2% were U.S. Treasuries, compared to 65.8%, 31.7% and 2.2%, respectively, at year-end 2014. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Deposits

Total deposits at March 31, 2015 were \$940.8 million, a \$8.2 million, or 0.9%, decrease when compared to the level at December 31, 2014. The decrease in total deposits was mainly due to declines in time deposits of \$11.3 million and \$4.7 million in money market and savings deposits, which were partially offset by an increase in non-interest bearing deposits of \$7.7 million.

Short-Term Borrowings

Short-term borrowings at March 31, 2015 and December 31, 2014 were \$5.1 million and \$4.8 million, respectively. Short-term borrowings generally consist of securities sold under agreements to repurchase, which are issued in conjunction with cash management services for commercial depositors, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank (the "FHLB"). Short-term advances are defined as those with original maturities of one year or less. At March 31, 2015 and December 31, 2014, short-term borrowings included only repurchase agreements.

Liquidity and Capital Resources

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. As seen in the Consolidated Statements of Cash Flows in the Financial Statements, the net decrease in cash was \$20.3 million for the first three months of 2015 compared to a net increase in cash of \$1.8 million for the first three months of 2014. The decline in cash in 2015 was mainly due to the purchase of investment securities that was partly funded by the proceeds from the stock sale in the second quarter of 2014.

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. The Banks had \$13 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at both March 31, 2015 and December 31, 2014. The Banks are also members of the FHLB, which provides another source of liquidity. Through the FHLB, the Banks had credit availability of approximately \$73.1 million and \$70.9 million at March 31, 2015 and December 31, 2014, respectively. These lines of credit are paid for monthly on a fee basis of 0.09%. CNB has pledged, under a blanket lien, all qualifying residential loans under borrowing agreements with the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity increased \$2.3 million to \$142.7 million at March 31, 2015 when compared to December 31, 2014 primarily due to current year's earnings and unrealized gains on available for sale securities.

Basel III

The FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer, comprised of common equity Tier 1 capital, is also established above the regulatory minimum capital requirements. This capital conservation buffer will be phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets.

The phase-in period for the final rules became effective for the Company on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of March 31, 2015, Talbot Bank was categorized as "adequately capitalized" and CNB as "well capitalized." Talbot Bank would be considered "well capitalized" based on its capital ratios as of March 31, 2015, however, must remain in the "adequately capitalized" category until the consent order is terminated by the FDIC and the Commissioner.

The following tables present the capital ratios for Shore Bancshares, Inc., Talbot Bank and CNB as of March 31, 2015 and December 31, 2014.

	Tier 1 leverage ratio	Common Equity Tier 1 ratio	Tier 1 risk-based capital ratio	Total risk-based capital ratio
March 31, 2015				
Company	10.93%	15.27%	15.27%	16.32%
Talbot Bank	9.36%	12.91%	12.91%	13.96%
CNB	9.56%	13.36%	13.36%	14.46%
	Tier 1 leverage ratio	Common Equity Tier 1 ratio	Tier 1 risk-based capital ratio	Total risk-based capital ratio
December 31, 2014				
Company	10.46%	n/a	15.27%	16.36%
Talbot Bank	8.91%	n/a	13.08%	14.16%
CNB	9.25%	n/a	13.55%	14.68%

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2014 under the caption “Market Risk Management and Interest Sensitivity”. Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2014.

Item 4. Controls and Procedures.

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

An evaluation of the effectiveness of these disclosure controls as of March 31, 2015 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, the Company’s management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level at March 31, 2015.

There was no change in our internal control over financial reporting during the first quarter of 2015 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2014. In the Company's Form 10-K for the year ended December 31, 2014, Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

Item 6. Exhibits.

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

SIGNATURES

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

SHORE BANCSHARES, INC.

Date: May 11, 2015

By: /s/ Lloyd L. Beatty, Jr.

Lloyd L. Beatty, Jr.
President & Chief Executive Officer
(Principal Executive Officer)

Date: May 11, 2015

By: /s/ George S. Rapp

George S. Rapp
Vice President & Chief Financial Officer
(Principal Financial Officer)

EXHIBIT INDEX

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

**Certifications of the Principal Executive Officer
Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14
As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Lloyd L. Beatty, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Shore Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 11, 2015

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

**Certifications of the Principal Accounting Officer
Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14
As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, George S. Rapp, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Shore Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 11, 2015

By: /s/ George S. Rapp
George S. Rapp
Vice President & Chief Financial Officer
(Principal Financial Officer)

Certification of Periodic Report
Pursuant to 18 U.S.C. Section 1350
As adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Pursuant to, and for purposes only of, 18 U.S.C. § 1350, the undersigned hereby certifies that (i) the Quarterly Report of Shore Bancshares, Inc. on Form 10-Q for the quarter ended March 31, 2015 filed with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (ii) information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Shore Bancshares, Inc.

Date: May 11, 2015

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

Date: May 11, 2015

By: /s/ George S. Rapp
George S. Rapp
Vice President & Chief Financial Officer
(Principal Financial Officer)
