Oak Valley Bancorp
Form 10-Q
November 14, 2016

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 September 30, 2016

OR

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

Commission file number 001-34142

OAK VALLEY BANCORP

(Exact name of registrant as specified in its charter)

California	**26-2326676**
State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification No.

125 N. Third Ave., Oakdale, CA 95361

(Address of principal executive offices)

(209) 848-2265

Issuer's telephone number

Not applicable

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,091,455 shares of common stock outstanding as of November 10, 2016.

Oak Valley Bancorp

September 30, 2016

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PART I – FINANCIAL STATEMENTS

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(dollars in thousands)	September 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	$ 133,243	$ 174,778
Federal funds sold	14,020	15,825
Cash and cash equivalents	147,263	190,603
Securities available for sale	160,077	131,546
Loans, net of allowance for loan loss of $7,767 and $7,356 at September 30, 2016 and December 31, 2015, respectively	592,650	530,394
Bank premises and equipment, net	13,712	14,277
Other real estate owned	1,485	2,066
Interest receivable and other assets	31,831	28,152
	$ 947,018	$ 897,038
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	$ 859,756	$ 814,691
Interest payable and other liabilities	4,404	4,084
Total liabilities	864,160	818,775
Shareholders' equity		
Common stock, no par value; 50,000,000 shares authorized, 8,093,555 and 8,078,155 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	24,682	24,682
Additional paid-in capital	3,412	3,217
Retained earnings	52,198	48,795
Accumulated other comprehensive income, net of tax	2,566	1,569
Total shareholders' equity	82,858	78,263
	$ 947,018	$ 897,038

The accompanying notes are an integral part of these consolidated financial statements.

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(dollars in thousands, except per share amounts)	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2016	2015	2016	2015
INTEREST INCOME				
Interest and fees on loans	$6,807	$5,515	$20,484	$16,293
Interest on securities available for sale	1,045	914	3,038	2,687
Interest on federal funds sold	4	8	18	24
Interest on deposits with banks	169	72	492	212
Total interest income	8,025	6,509	24,032	19,216
INTEREST EXPENSE				
Deposits	196	155	555	461
Total interest expense	196	155	555	461
Net interest income	7,829	6,354	23,477	18,755
Provision for (reversal of) loan losses	90	0	415	(125)
Net interest income after provision for (reversal of) loan losses	7,739	6,354	23,062	18,880
OTHER INCOME				
Service charges on deposits	341	307	1,011	927
Earnings on cash surrender value of life insurance	102	108	305	322
Mortgage commissions	49	26	144	114
Net gain on sales and calls of securities	10	3	28	186
Other	575	521	1,682	1,599
Total non-interest income	1,077	965	3,170	3,148
OTHER EXPENSES				
Salaries and employee benefits	3,225	2,852	9,950	8,790
Occupancy expenses	819	743	2,470	2,214
Data processing fees	435	366	1,346	1,077
Regulatory assessments (FDIC & DBO)	178	123	505	368
Other operating expenses	1,267	1,215	4,027	3,141
Total non-interest expense	5,924	5,299	18,298	15,590
Net income before provision for income taxes	2,892	2,020	7,934	6,438
PROVISION FOR INCOME TAXES	962	638	2,591	2,020
NET INCOME	$1,930	$1,382	$5,343	$4,418

NET INCOME PER COMMON SHARE	$0.24	$0.17	$0.67	$0.55
NET INCOME PER DILUTED COMMON SHARE	$0.24	$0.17	$0.66	$0.55

The accompanying notes are an integral part of these consolidated financial statements.

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
(in thousands)	2016	2015	2016	2015
Net income	$1,930	$1,382	$5,343	$4,418
Other comprehensive income (loss):				
Unrealized holding (losses) gains on securities arising during the current period, net of tax effect of ($108) thousand and $709 thousand for the three and nine month periods ended September 30, 2016 and 2015, respectively, and $290 thousand and ($492) thousand for the comparable 2015 periods	(154)	415	1,014	(704)
Reclassification adjustment due to net gains realized on sales and calls of securities, net of tax effect of $4 thousand and $11 thousand for the three and nine months ended September 30, 2016, respectively, and $1 thousand and $77 thousand for the comparable 2015 periods	(6)	(2)	(17)	(109)
Other comprehensive income (loss)	(160)	413	997	(813)
Comprehensive income	$1,770	$1,795	$6,340	$3,605

The accompanying notes are an integral part of these consolidated financial statements.

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

	YEAR ENDED DECEMBER 31, 2015 AND NINE MONTHS ENDED SEPTEMBER 30, 2016					
(dollars in thousands)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2015	8,074,855	$24,682	$ 2,910	$45,582	$ 1,867	$ 75,041
Tax benefit on stock based compensation			46			46
Restricted stock issued	6,000					0
Restricted stock forfeited	(2,700)					0
Cash dividends declared				(1,695)		(1,695)
Stock based compensation			261			261
Other comprehensive loss					(298)	(298)
Net income				4,908		4,908
Balances, December 31, 2015	8,078,155	$24,682	$ 3,217	$48,795	$ 1,569	$ 78,263
Restricted stock issued	17,000					$ 0
Restricted stock forfeited	(1,600)					
Cash dividends declared				(1,940)		(1,940)
Stock based compensation			195			195
Other comprehensive income					997	997
Net income				5,343		5,343
Balances, September 30, 2016	8,093,555	$24,682	$ 3,412	$52,198	$ 2,566	$ 82,858

The accompanying notes are an integral part of these consolidated financial statements

OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(dollars in thousands)	NINE MONTHS ENDED SEPTEMBER 30, 2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$5,343	$4,418
Adjustments to reconcile net earnings to net cash from operating activities:		
Provision (reversal of provision) for loan losses	415	(125)
Decrease in deferred fees/costs, net	(29)	(123)
Depreciation	948	892
Amortization of investment securities, net	270	132
Stock based compensation	195	197
Gain on sale of premises and equipment	(4)	(5)
OREO write downs and losses on sale	88	50
Gain on sales and calls of available for sale securities	(28)	(186)
Earnings on cash surrender value of life insurance	(305)	(322)
Gain on BOLI death benefit	(2)	(66)
Increase (decrease) in interest payable and other liabilities	320	(1,044)
Decrease in interest receivable	52	75
Increase in other assets	(228)	(178)
Net cash from operating activities	7,035	3,715
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(47,182)	(34,506)
Proceeds from maturities, calls, and principal paydowns of securities available for sale	20,103	24,958
Net increase in loans	(62,895)	(22,876)
Purchase of FHLB Stock	(79)	0
Purchase of BOLI policies	(4,000)	0
Proceeds from sale of OREO	746	0
Proceeds from redemption of BOLI policies	186	292
Proceeds from sales of premises and equipment	4	5
Net purchases of premises and equipment	(383)	(562)
Net cash used in investing activities	(93,500)	(32,689)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Shareholder cash dividends paid	(1,940)	(1,696)
Net increase in demand deposits and savings accounts	40,612	43,078
Net increase (decrease) in time deposits	4,453	(82)
Net cash from financing activities	43,125	41,300
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(43,340)	12,326

CASH AND CASH EQUIVALENTS, beginning of period	190,603	144,288
CASH AND CASH EQUIVALENTS, end of period	$147,263	$156,614
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$558	$466
Income taxes	$1,434	$3,545
NON-CASH INVESTING ACTIVITIES:		
Real estate acquired through foreclosure	$253	$0
Change in unrealized gain (loss) on available-for-sale securities	$1,694	$(1,382)

The accompanying notes are an integral part of these consolidated financial statements.

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OAK VALLEY BANCORP

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – BASIS OF PRESENTATION

On July 3, 2008 (the "Effective Date"), a bank holding company reorganization was completed whereby Oak Valley Bancorp ("the Company") became the parent holding company for Oak Valley Community Bank (the "Bank"). On the Effective Date, a tax-free exchange was completed whereby each outstanding share of the Bank was converted into one share of the Company and the Bank became the sole wholly-owned subsidiary of the holding company.

On December 23, 2015, the Company completed its acquisition of Mother Lode Bank ("MLB"), a California state-chartered bank headquartered in Sonora, California, in a transaction in which Mother Lode Bank was merged with and into the Bank, with the Bank as the surviving company in the transaction. The purchase price for Mother Lode Bank was approximately $7.3 million. As of the acquisition date, Mother Lode Bank's total assets were $78.7 million and total deposits were $71.1 million.

Oak Valley Community Bank is a California State chartered bank. The Bank was incorporated under the laws of the state of California on May 31, 1990, and began operations in Oakdale on May 28, 1991. The Company operates branches in Oakdale, Sonora, Bridgeport, Bishop, Mammoth Lakes, Modesto, Manteca, Patterson, Turlock, Ripon, Stockton, Tracy and Escalon, California. The Bridgeport, Mammoth Lakes, and Bishop branches operate as a separate division, Eastern Sierra Community Bank. The Company's primary source of revenue is providing loans to customers who are predominantly middle-market businesses.

The consolidated financial statements include the accounts of the Company and its wholly-owned bank subsidiary. All material intercompany transactions have been eliminated. In the opinion of Management, the consolidated financial statements contain all adjustments necessary to present fairly the financial position, results of operations, changes in shareholders' equity and cash flows. All adjustments are of a normal, recurring nature.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant accounting estimates reflected in the Company's consolidated financial statements include the allowance for loan losses, determination of non-accrual loans, other-than-temporary impairment of investment securities, the fair value measurements, deferred compensation plans, and the determination, recognition and measurement of impaired loans. Actual results could differ from these

estimates.

The interim consolidated financial statements included in this report are unaudited but reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the interim periods presented. All such adjustments are of a normal recurring nature. The results of operations for the three and nine month periods ended September 30, 2016 are not necessarily indicative of the results of a full year's operations. Certain prior year amounts have been reclassified to conform to the current year presentation. There was no effect on net income or shareholders' equity as a result of reclassifications. For further information, refer to the audited consolidated financial statements and footnotes included in the Company's Form 10-K for the year ended December 31, 2015.

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

In September, 2015, the FASB issued ASU No. 2015-16, Simplifying the Accounting for Measurement Period Adjustments (Topic 805). This ASU eliminates the requirement to restate prior period financial statements for measurement period adjustments to assets acquired and liabilities assumed in a business combination. The new guidance under this update requires the cumulative impact of measurement period adjustments be recognized in the period the adjustment is determined. This update does not change what constitutes a measurement period adjustment, nor does it change the length of the measurement period. The new standard is effective for interim annual periods beginning after December 15, 2015 and should be applied prospectively to measurement period adjustments that occur after the effective date. The adoption of this update is not expected to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in this ASU make improvements to GAAP related to financial instruments that include the following as applicable to us.

Equity investments, except for those accounted for under the equity method of accounting or those that result in consolidation of the investee, are required to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment - if impairment exists, this requires measuring the investment at fair value.

Eliminates the requirement for public companies to disclose the method(s) and significant assumptions used to estimate the fair value that is currently required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

Public companies will be required to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements.

The reporting entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

ASU 2016-01 is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This ASU will impact our financial statement disclosures, however, we do not expect this ASU to have a material impact on our financial condition or results of operations.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities, including leases classified as operating leases under previous GAAP, on the balance sheet and requiring additional disclosures of key information about leasing arrangements. ASU 2016-02 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2018 and requires a modified retrospective approach to adoption. Early application of the amendments is permitted. We are currently evaluating the provisions of this ASU and will be monitoring developments and additional guidance to determine the potential outcome the amendments will have on our financial condition and results of operations.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326).* This update changes the methodology used by financial institutions under current U.S. GAAP to recognize credit losses in the financial statements. Currently, U.S. GAAP requires the use of the incurred loss model, whereby financial institutions recognize in current period earnings, incurred credit losses and those inherent in the financial statements, as of the date of the balance sheet. This guidance results in a new model for estimating the allowance for loan and lease losses, commonly referred to as the Current Expected Credit Loss ("CECL") model. Under the CECL model, financial institutions are required to estimate future credit losses and recognize those losses in current period earnings. The amendments within the update are effective for fiscal years and all interim periods beginning after December 15, 2019, with early adoption permitted. Upon adoption of the amendments within this update, the Company will be

required to make a cumulative-effect adjustment to the opening balance of retained earnings in the year of adoption. The Company is currently in the process of evaluating the impact the adoption of this update will have on its financial statements.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments (Topic 230).* This update clarifies how entities should classify certain cash receipts and cash payments on the statement of cash flows with the objective of reducing the existing diversity in practice related to eight specific cash flow issues. The amendments in this update are effective for annual periods beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of the amendments within this update will have a material impact on the Company's financial statements.

NOTE 3 – ACQUISITION

On December 23, 2015, in effort to expand our market presence and enhance shareholder value, the Company acquired Mother Lode Bank ("MLB"), via a merger with and into the Bank, upon the consummation of which all outstanding common shares and unexercised options to purchase MLB common stock were cancelled, in exchange for $7,336,000 in cash (the "MLB Acquisition"). On January 29, 2016, the two acquired MLB branches in Sonora were closed after management determined that our two existing branches in Sonora would be able to support our acquired customers. The assets acquired and liabilities assumed, both tangible and intangible, were recorded at their fair values as of the acquisition date in accordance with ASC 805.

During the third quarter of 2016, the Company determined that deferred tax assets acquired from MLB totaling $2,651,000, mainly from net operating loss carryforwards, cannot be utilized by the Company. As a result, the Company decreased deferred tax assets and increased goodwill by $2,651,000 as of the December 23, 2015 acquisition date in the tables below. Additionally, all related financial statement disclosures have been revised. These revisions did not impact previously reported net income or shareholders equity.

The following table reflects the estimated fair values of the assets acquired and liabilities assumed related to the MLB Acquisition:

(Dollars in thousands)	Acquisition Date December 23, 2015
Assets:	
Cash and cash equivalents	$ 30,804
Loans	42,831
Core deposit intangible	1,031
Goodwill	3,312
Other assets	738
Total assets acquired	$ 78,717
Liabilities:	
Deposits:	
Non-interest bearing	$ 36,177
Interest bearing	
Transaction accounts	6,112
Savings accounts	15,727
Money market accounts	7,602
Other time accounts	5,507
Total deposits	71,125
Other liabilities	256
Total liabilities assumed	$ 71,381
Merger consideration	$ 7,336

The following table presents the net assets acquired from MLB and the estimated fair value adjustments:

(Dollars in thousands)	Acquisition Date December 23, 2015
Book value of net assets acquired from Mother Lode Bank	$ 4,884
Fair value adjustments:	
Loans	(2,960)
Reversal of Allowance for Loan Loss	1,279
Core deposit intangible asset	1,031
Other assets & liabilities, net	(210)
Total purchase accounting adjustments	$ (860)
Fair value of net assets acquired from Mother Lode Bank	$ 4,024
Merger consideration	7,336
Less: fair value of net assets acquired	(4,024)
Goodwill	$ 3,312

As a result of the MLB Acquisition, we recorded $3,312,000 in goodwill, which represents the excess of the total purchase price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed. Goodwill mainly reflects expected value created through the combined operations of MLB and the Company. At December 31, 2015, we determined that the fair value of our traditional community banking activities (provided through our branch network) exceeded the carrying amount. Therefore, no impairment on goodwill has been recorded. The following is a description of the methods used to determine the fair values of significant assets and liabilities at acquisition date presented above.

Loans

The fair values for acquired loans were developed based upon the present values of the expected cash flows utilizing market-derived discount rates. Expected cash flows for each acquired loan were projected based on contractual cash flows adjusted for expected prepayment, expected default (i.e. probability of default and loss severity), and principal recovery.

Prepayment rates were applied to the principal outstanding based on the type of loan, where appropriate. Prepayments were based on a constant prepayment rate (“CPR”) applied across the life of a loan. The annual CPRs were between 0% and 5%, depending on the characteristics of the loan pool (e.g. construction, commercial real estate, etc.).

Non-credit-impaired loans with similar characteristics were grouped together and were treated in the aggregate when applying the discount rate on the expected cash flows. Aggregation factors considered included the type of loan and related collateral, risk classification, fixed or variable interest rate, term of loan and whether or not the loan was amortizing. See Note 5 for additional information.

Core Deposit Intangible

The core deposit intangible represents the estimated future benefits of acquired deposits and is booked separately from the related deposits. The value of the core deposit intangible asset was determined using a discounted cash flow approach to arrive at the cost differential between the core deposits (non-maturity deposits such as transaction, savings and money market accounts) and alternative funding sources. A core deposit intangible asset of $1,031,000 was recorded on December 23, 2015, of which $39,000 and $120,000 was amortized during the three and nine month periods ended September 30, 2016, respectively. The core deposit intangible is amortized on an accelerated basis over an estimated ten-year life, and it is evaluated periodically for impairment. No impairment loss was recognized as of September 30, 2016.

Acquisition Related Expenses

Acquisition-related expenses are recognized as incurred and continue until all systems have been converted and operational functions become fully integrated. We incurred one-time third-party acquisition-related expenses in the consolidated statements of income totaling $49,000 and $190,000 during the three and nine month periods ended September 30, 2016, respectively. The conversion of the operating systems was completed in April 2016.

NOTE 4 – SECURITIES

The amortized cost and estimated fair values of debt securities as of September 30, 2016 are as follows:

(dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
U.S. agencies	$ 28,940	$ 1,078	$ (3)	$30,015
Collateralized mortgage obligations	4,329	18	(3)	4,344
Municipalities	73,649	3,923	(19)	77,553
SBA pools	5,209	1	(9)	5,201
Corporate debt	21,347	113	(395)	21,065
Asset backed securities	19,003	4	(218)	18,789
Mutual fund	3,240	0	(130)	3,110
	$ 155,717	$ 5,137	$ (777)	$160,077

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2016.

(dollars in thousands)	Less than 12 months		12 months or more		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. agencies	$744	$ (3)	$0	$ 0	$744	$ (3)
Collateralized mortgage obligations	3,270	(3)	0	0	3,270	(3)
Municipalities	5,572	(15)	427	(4)	5,999	(19)
SBA pools	2,152	(5)	772	(4)	2,924	(9)
Corporate debt	12,162	(372)	972	(23)	13,134	(395)
Asset backed securities	5,128	(45)	10,165	(173)	15,293	(218)
Mutual fund	0	0	3,109	(130)	3,109	(130)
Total temporarily impaired securities	$29,028	$ (443)	$15,445	$ (334)	$44,473	$ (777)

At September 30, 2016, there was one U.S municipality, two SBA pools, three corporate debts, six asset backed securities and one mutual fund that comprised the total securities in an unrealized loss position for greater than 12 months and one U.S. agency, two collateralized mortgage obligations, six municipalities, one SBA pool, seven corporate debts and two asset backed securities that make up the total securities in a loss position for less than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security's fair value. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Company does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

The amortized cost and estimated fair value of investment securities at September 30, 2016, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(dollars in thousands)	**Amortized Cost**	**Fair Value**
Available-for-sale securities:		
Due in one year or less	$ 10,008	$ 10,696
Due after one year through five years	48,629	49,721
Due after five years through ten years	62,904	64,489
Due after ten years	34,176	35,171
	$ 155,717	$ 160,077

The amortized cost and estimated fair values of debt securities as of December 31, 2015, are as follows:

(dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Available-for-sale securities:				
U.S. agencies	$ 31,815	$ 1,142	$ (89)	$ 32,868
Collateralized mortgage obligations	2,729	17	(27)	2,719
Municipalities	66,535	2,248	(197)	68,586
SBA pools	811	0	(5)	806
Corporate debt	13,497	44	(121)	13,420
Asset backed securities	10,321	0	(183)	10,138
Mutual fund	3,172	0	(163)	3,009
	$ 128,880	$ 3,451	$ (785)	$ 131,546

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2015.

(dollars in thousands)	**Less than 12 months**		**12 months or more**		**Total**	
Description of Securities	**Fair**	**Unrealized**	**Fair**	**Unrealized**	**Fair**	**Unrealized**

	Value	Loss	Value	Loss	Value	Loss
U.S. agencies	$7,129	$ (30)	$1,800	$ (59)	$8,929	$ (89)
Collateralized mortgage obligations	0	0	1,266	(27)	1,266	(27)
Municipalities	11,451	(123)	3,680	(74)	15,131	(197)
SBA pools	0	0	807	(5)	807	(5)
Corporate debt	9,376	(121)	0	0	9,376	(121)
Asset backed securities	5,351	(78)	4,787	(105)	10,138	(183)
Mutual fund	0	0	3,009	(163)	3,009	(163)
Total temporarily impaired securities	$33,307	$ (352)	$15,349	$ (433)	$48,656	$ (785)

We recognized gross gains of $10,000 and $29,000 for the three and nine month periods ended September 30, 2016, respectively, on certain available-for-sale securities that were called or sold, which compares to $3,000 and $218,000 in the same periods of 2015. There were no securities sold during the first nine months of 2016, compared to two available-for-sale securities sold during the first nine months of 2015, which resulted in a gross loss of $32,000 on one sale and a gross gain of $13,000 on the other sale.

Securities carried at $83,423,000 and $65,902,000 at September 30, 2016 and December 31, 2015, respectively, were pledged to secure deposits of public funds.

NOTE 5 – LOANS

Our customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of September 30, 2016, approximately 78% of the Company's loans are commercial real estate loans which include construction loans. Approximately 11% of the Company's loans are for general commercial uses including professional, retail, and small business. Additionally, 6% of the Company's loans are for residential real estate and other consumer loans. The remaining 5% are agriculture loans. Loan totals were as follows:

(in thousands)	September 30, 2016	December 31, 2015
Commercial real estate:		
Commercial real estate- construction	$ 18,861	$ 19,363
Commercial real estate- mortgages	384,164	363,644
Land	9,561	10,239
Farmland	56,651	29,801
Commercial and industrial	68,073	63,776
Consumer	736	774
Consumer residential	36,756	32,588
Agriculture	27,767	20,847
Total loans	602,569	541,032
Less:		
Deferred loan fees and costs, net	(2,152)	(3,282)
Allowance for loan losses	(7,767)	(7,356)
Net loans	$ 592,650	$ 530,394

Loan Origination/Risk Management. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentration of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and solid business acumen, our management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash

flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company’s commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Company’s exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At September 30, 2016 and December 31, 2015, commercial real estate loans equal to approximately 41.4% and 44.3%, respectively, of the outstanding principal balance of our commercial real estate loans were secured by owner-occupied properties.

With respect to loans to developers and builders that are secured by non-owner occupied properties that the Company may originate from time to time, the Company generally requires the borrower to have had an existing relationship with the Company and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Agricultural production, real estate and development lending is susceptible to credit risks including adverse weather conditions, pest and disease, as well as market price fluctuations and foreign competition. Agricultural loan underwriting standards are maintained by following Company policies and procedures in place to minimize risk in this lending segment. These standards consist of limiting credit to experienced farmers who have demonstrated farm management capabilities, requiring cash flow projections displaying margins sufficient for repayment from normal farm operations along with equity injected as required by policy, as well as providing adequate secondary repayment and sponsorship including satisfactory collateral support. Credit enhancement obtained through government guarantee programs may also be used to provide further support as available.

The Company originates consumer loans utilizing common underwriting criteria specified in policy. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for 1-4 family, home equity lines and loans follow bank policy, which include, but are not limited to, a maximum loan-to-value percentage of 80%, a maximum housing and total debt ratio of 36% and 42%, respectively and other specified credit and documentation requirements.

The Company maintains an independent loan review department that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Bank's policies and procedures.

Purchased Credit-Impaired ("PCI") Loans. We evaluated loans purchased in the Acquisition in accordance with accounting guidance in ASC 310-30 related to loans acquired with deteriorated credit quality. Acquired loans are considered credit-impaired if there is evidence of significant deterioration of credit quality since origination and it is probable, at the acquisition date, that we will be unable to collect all contractually required payments receivable. Management has determined certain loans purchased in the MLB Acquisition to be PCI loans based on credit

indicators such as nonaccrual status, past due status, loan risk grade, loan-to-value ratio, etc. Revolving credit agreements (e.g., home equity lines of credit and revolving commercial loans) are not considered PCI loans as cash flows cannot be reasonably estimated.

For acquired loans not considered credit-impaired, the difference between the contractual amounts due (principal amount) and the fair value is accounted for subsequently through accretion. We recognize discount accretion based on the acquired loan's contractual cash flows using an effective interest rate method. The accretion is recognized through the net interest margin.

The following table presents the fair value of purchased credit-impaired and other loans acquired from Mother Lode Bank as of the acquisition date:

(in thousands)	December 23, 2015		
	Purchased credit-impaired loans	Other purchased loans	Total
Contractually required payments including interest	$1,982	$ 44,007	$45,989
Less: nonaccretable difference	(1,103)	0	(1,103)
Cash flows expected to be collected (undiscounted)	879	44,007	44,886
Accretable yield	(14)	(2,041)	(2,055)
Fair value of purchased loans	$865	$ 41,966	$42,831

The following table reflects the outstanding balance and related carrying value of PCI loans as of September 30, 2016 and December 31, 2015:

(in thousands)	September 30, 2016		December 31, 2015	
Commercial real estate:	Unpaid principal balance	Carrying value	Unpaid principal balance	Carrying value
Commercial real estate- construction	$0	$ 0	$0	$ 0
Commercial real estate- mortgages	0	0	196	118
Land	280	33	795	269
Farmland	0	0	0	0
Commercial and industrial	499	499	794	478
Consumer	0	0	0	0
Consumer residential	0	0	0	0
Agriculture	0	0	0	0
Total purchased credit-impaired loans	$779	$ 532	$1,785	$ 865

For the PCI loans, the accretable yield represents the excess of the cash flows expected to be collected at acquisition over the fair value of the loans at the acquisition date, and is accreted into interest income over the estimated remaining life of the purchased credit-impaired loans using the effective yield method, provided that the timing and amount of future cash flows is reasonably estimable. The cash flows expected to be collected are updated each quarter based on current assumptions regarding default rates, loss severities, and other factors that are reflective of current market conditions. Probable decreases in expected cash flows after acquisition result in the recognition of impairment as a specific allowance for loan losses or a charge-off to the allowance. The accretable yield balance for PCI loans was $14,000 at December 31, 2015, all of which was accreted to interest income during the first quarter of 2016, as each of the PCI loans had short-term maturities. The nonaccretable difference represents the difference between the undiscounted contractual cash flows and the undiscounted expected cash flows, and also reflects the estimated credit losses in the acquired loan portfolio at the acquisition date and can fluctuate due to changes in expected cash flows during the life of the PCI loans.

Non-Accrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future

payments are reasonably assured.

Non-accrual loans, segregated by class of loans, were as follows:

(in thousands)	September 30, 2016	December 31, 2015
Commercial real estate:		
Land	$ 2,305	$ 2,739
Farmland	0	51
Commercial and industrial	309	322
Agriculture	0	2,704
Total non-accrual loans	$ 2,614	$ 5,816

Excluded from the above non-accrual loan table are the carrying values of Purchased Credit Impaired loans acquired in the MLB Acquisition.

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income of approximately $38,000 and $118,000 in the three and nine month periods ended September 30, 2016, respectively, as compared to $71,000 and $224,000 in the same periods of 2015.

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of September 30, 2016 (in thousands):

September 30, 2016	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Purchased Credit Impaired Loans	Total	Greater Than 90 Days Past Due and Still Accruing
Commercial real estate:								
Commercial R.E. - construction	$0	$ 0	$0	$0	$18,861	$ 0	$18,861	$ 0
Commercial R.E. - mortgages	0	0	0	0	384,164	0	384,164	0
Land	289	0	2,296	2,585	6,943	33	9,561	0
Farmland	0	0	0	0	56,651	0	56,651	0
Commercial and industrial	0	0	304	304	67,270	499	68,073	0
Consumer	27	0	0	27	709	0	736	0
Consumer residential	0	0	0	0	36,756	0	36,756	0
Agriculture	0	0	0	0	27,767	0	27,767	0
Total	$316	$ 0	$2,600	$2,916	$599,121	$ 532	$602,569	$ 0

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of December 31, 2015 (in thousands):

December 31, 2015	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Purchased Credit Impaired Loans	Total	Greater Than 90 Days Past Due and Still Accruing
Commercial real estate:								

Commercial R.E. - construction	$0	$0	$0	$0	$19,363	$ 0	$19,363	$ 0
Commercial R.E. – mortgages	0	0	0	0	363,526	118	363,611	0
Land	0	0	2,261	2,261	7,709	269	10,239	0
Farmland	1,182	0	51	1,233	28,568	0	29,801	0
Commercial and industrial	352	0	312	664	62,634	478	63,776	0
Consumer	0	0	0	0	774	0	774	0
Consumer residential	0	0	0	0	32,588	0	32,588	0
Agriculture	0	2,704	0	2,704	18,143	0	20,847	0
Total	$1,534	$2,704	$2,624	$6,862	$533,305	$ 865	$541,032	$ 0

Impaired Loans. Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. There was no interest income realized on impaired loans for the three months ended September 30, 2016 and 2015.

Impaired loans as of September 30, 2016 and December 31, 2015 are set forth in the following tables. PCI loans are excluded from the tables below, as they have not experienced post acquisition declines in cash flows expected to be collected.

(in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
September 30, 2016					
Commercial real estate:					
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	2,712	744	1,561	2,305	680
Farmland	0	0	0	0	0
Commercial and Industrial	354	309	0	309	0
Consumer	0	0	0	0	0
Consumer residential	0	0	0	0	0
Agriculture	0	0	0	0	0
Total	$ 3,066	$ 1,053	$ 1,561	$ 2,614	$ 680
December 31, 2015					
Commercial real estate:					
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	3,856	0	2,739	2,739	722
Farmland	63	51	0	51	0
Commercial and Industrial	357	322	0	322	0
Consumer	0	0	0	0	0
Consumer residential	0	0	0	0	0
Agriculture	2,704	2,704	0	2,704	0
Total	$ 6,980	$ 3,077	$ 2,739	$ 5,816	$ 722

Average recorded investment in impaired loans outstanding as of September 30, 2016 and 2015 is set forth in the following table.

Average Recorded Investment for the

(in thousands)	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Commercial real estate:				
Commercial R.E. - construction	$0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	216
Land	2,324	2,931	2,439	2,961
Farmland	0	59	0	64
Commercial and Industrial	312	1,335	316	1,182
Consumer	0	0	0	0
Consumer residential	0	0	0	0
Agriculture	0	0	0	0
Total	$2,636	$ 4,325	$ 2,755	$ 4,423

Troubled Debt Restructurings – In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's internal underwriting policy.

At September 30, 2016, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $2,614,000. At December 31, 2015, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $3,060,000. At September 30, 2016 and December 31, 2015 there were no unfunded commitments on loans classified as a troubled debt restructures. We have allocated $680,000 and $722,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of September 30, 2016 and December 31, 2015, respectively.

The modification of the terms of such loans typically includes one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date; or a temporary payment modification in which the payment amount allocated towards principal was reduced. In some cases, a permanent reduction of the accrued interest on the loan is conceded. During the nine months ended September 30, 2016, one loan was modified as troubled debt restructuring by extending the maturity date. During the three and nine month periods ended September 30, 2015, the terms of one and two loans, respectively, were modified as troubled debt restructurings by extending the maturity dates.

The following tables present loans by class modified as troubled debt restructurings that occurred during the three and nine month periods ended September 30, 2016 and 2015:

(dollars in thousands)	Three Months Ended September 30, 2016			Three Months Ended September 30, 2015		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate:						
Commercial R.E. - construction	0	$ 0	$ 0	0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0	0
Land	1	292	292	0	0	0
Farmland	0	0	0	0	0	0
Commercial and industrial	0	0	0	0	0	0
Consumer	0	0	0	0	0	0
Consumer residential	0	0	0	0	0	0

Agriculture	0	0	0	0	0	0
Total	1	$ 292	$ 292	0	$ 0	$ 0

(dollars in thousands)	Nine Months Ended September 30, 2016			Nine Months Ended September 30, 2015		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate:						
Commercial R.E. - construction	0	$ 0	$ 0	0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0	0
Land	1	292	292	1	570	570
Farmland	0	0	0	0	0	0
Commercial and industrial	0	0	0	1	24	24
Consumer	0	0	0	0	0	0
Consumer residential	0	0	0	0	0	0
Agriculture	0	0	0	0	0	0
Total	1	$ 292	$ 292	2	$ 594	$ 594

The troubled debt restructuring during the nine months ended September 30, 2016 did not increase the allowance for loan losses as a result of loan modifications. There were no charge-offs as a result of loan modifications, as the contractual balances outstanding were determined to be collectible.

There were no loans modified as troubled debt restructurings within the previous twelve months and for which there was a payment default during the three and nine month periods ended September 30, 2016 and 2015. A loan is considered to be in payment default once it is ninety days contractually past due under the modified terms.

Loan Risk Grades– Quality ratings (Risk Grades) are assigned to all commitments and stand-alone notes. Risk grades define the basic characteristics of commitments or stand-alone note in relation to their risk. All loans are graded using a system that maximizes the loan quality information contained in loan review grades, while ensuring that the system is compatible with the grades used by bank examiners.

We grade loans using the following letter system:

1 Exceptional Loan

2 Quality Loan

3A Better Than Acceptable Loan

3B Acceptable Loan

3C Marginally Acceptable Loan

4 (W) Watch Acceptable Loan

5 Other Loans Especially Mentioned

6 Substandard Loan

7 Doubtful Loan

8 Loss

1. Exceptional Loan - Loans with A+ credits that contain very little, if any, risk. Grade 1 loans are considered Pass. To qualify for this rating, the following characteristics must be present:

-A high level of liquidity and whose debt-servicing capacity exceeds expected obligations by a substantial margin.

-Where leverage is below average for the industry and earnings are consistent or growing without severe vulnerability to economic cycles.

-Also included in this rating (but not mandatory unless one or more of the preceding characteristics are missing) are loans that are fully secured and properly margined by our own time instruments or U.S. blue chip securities. To be properly margined cash collateral must be equal to, or greater than, 110% of the loan amount.

2. Quality Loan - Loans with excellent sources of repayment that conform in all respects to bank policy and regulatory requirements. These are also loans for which little repayment risk has been identified. No credit or collateral exceptions. Grade 2 loans are considered Pass. Other factors include:

-Unquestionable debt-servicing capacity to cover all obligations in the ordinary course of business from well-defined primary and secondary sources.

-Consistent strong earnings.

-A solid equity base.

3A. Better than Acceptable Loan - In the interest of better delineating the loan portfolio's true credit risk for reserve allocation, further granularity has been sought by splitting the grade 3 category into three classifications. The distinction between the three are bank-defined guidelines and represent a further refinement of the regulatory definition of a pass, or grade 3 loan. Grade 3A is the stronger third of the pass category, but is not strong enough to be a grade 2 and is characterized by:

-Strong earnings with no loss in last three years and ample cash flow to service all debt well above policy guidelines.

-Long term experienced management with depth and defined management succession.

-The loan has no exceptions to policy.

-Loan-to-value on real estate secured transactions is 10% to 20% less than policy guidelines.

-Very liquid balance sheet that may have cash available to pay off our loan completely.

-Little to no debt on balance sheet.

3B. Acceptable Loan - 3B loans are simply defined as all loans that are less qualified than 3A loans and are stronger than 3C loans. These loans are characterized by acceptable sources of repayment that conform to bank policy and regulatory requirements. Repayment risks are acceptable for these loans. Credit or collateral exceptions are minimal, are in the process of correction, and do not represent repayment risk. These loans:

-Are those where the borrower has average financial strengths, a history of profitable operations and experienced management.

-Are those where the borrower can be expected to handle normal credit needs in a satisfactory manner.

3C. Marginally Acceptable - 3C loans have similar characteristics as that of 3Bs with the following additional characteristics:

Requires collateral. A credit facility where the borrower has average financial strengths, but usually lacks reliable secondary sources of repayment other than the subject collateral. Other common characteristics can include some or all of the following: minimal background experience of management, lacking continuity of management, a start-up operation, erratic historical profitability (acceptable reasons-well identified), lack of or marginal sponsorship of guarantor, and government guaranteed loans.

4W Watch Acceptable - Watch grade will be assigned to any credit that is adequately secured and performing but monitored for a number of indicators. These characteristics may include any unexpected short-term adverse financial performance from budgeted projections or prior period's results (i.e., declining profits, sales, margins, cash flow, or increased reliance on leverage, including adverse balance sheet ratios, trade debt issues, etc.). Additionally, any managerial or personal problems of company management, decline in the entire industry or local economic conditions failure to provide financial information or other documentation as requested; issues regarding delinquency, overdrafts, or renewals; and any other issues that cause concern for the company. Loans to individuals or loans supported by guarantors with marginal net worth and/or marginal collateral. Weakness identified in a Watch credit is short-term in nature. Loans in this category are usually accounts the Bank would want to retain providing a positive turnaround can be expected within a reasonable time frame. Grade 4 loans are considered Pass.

5 Other Loans Especially Mentioned (Special Mention) - A special mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date result in the deterioration of the repayment prospects for the credit or the institution's credit position. Extensions of credit that might be detailed in this category include the following:

-The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement.

-Questions exist regarding the condition of and/or control over collateral.

-Economic or market conditions may unfavorably affect the obligor in the future.

-A declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized.

6 Substandard Loan - A "substandard" extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

7 Doubtful Loan - An extension of credit classified “doubtful” has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral or refinancing plans. The entire loan need not be classified doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the Bank. In this situation, estimates are based on liquidation value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent.

A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss. A credit classified as doubtful should be resolved within a ‘reasonable’ period of time. Reasonable is generally defined as the period between examinations. In other words, a credit classified doubtful at an examination should be cleared up before the next exam. However, there may be situations that warrant continuation of the doubtful classification a while longer.

8 Loss - Extensions of credit classified “loss” are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off, even though partial recovery may be affected in the future. It should not be the Company’s practice to attempt long-term recoveries while the credit remains on the books. Losses should be taken in the period in which they surface as uncollectible.

As of September 30, 2016 and December 31, 2015, there are no loans that are classified with a risk grade of *8- Loss.*

The following table presents weighted average risk grades of our loan portfolio:

	September 30, 2016 Weighted Average Risk Grade	December 31, 2015 Weighted Average Risk Grade
Commercial real estate:		
Commercial real estate - construction	3.11	3.72
Commercial real estate - mortgages	3.01	3.16
Land	4.30	4.58
Farmland	3.00	3.12
Commercial and industrial	3.00	3.57
Consumer	2.24	1.99
Consumer residential	2.97	3.01
Agriculture	3.08	3.39
Total gross loans	3.03	3.25

The following table presents risk grade totals by class of loans as of September 30, 2016 and December 31, 2015. Risk grades 1 through 4 have been aggregated in the "Pass" line.

(in thousands)	Commercial R.E. Construction	Commercial R.E. Mortgages	Land	Farmland	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Total
September 30, 2016									
Pass	$ 17,827	$ 383,023	$ 6,780	$ 56,651	$ 65,977	$ 708	$ 36,347	$ 27,767	$ 595,080
Special mention	1,034	1,072	-	-	338	-	33	-	2,477
Substandard	-	69	2,501	-	1,758	28	376	-	4,732
Doubtful	-	-	280	-	-	-	-	-	280
Total loans	$ 18,861	$ 384,164	$ 9,561	$ 56,651	$ 68,073	$ 736	$ 36,756	$ 27,767	$ 602,569
December 31, 2015									
Pass	$ 18,312	$ 357,339	$ 6,358	$ 28,568	$ 55,957	$ 745	$ 32,532	$ 18,143	$ 517,954

Special mention	-	4,389	110	-	6,153	-	-	-	10,652
Substandard	1,051	1,916	3,283	1,233	1,416	29	56	2,704	11,688
Doubtful	-	-	488	-	250	-	-	-	738
Total loans	$ 19,363	$ 363,644	$ 10,239	$ 29,801	$ 63,776	$ 774	$ 32,588	$ 20,847	$ 541,032

Allowance for Loan Losses. The allowance for loan losses is a reserve established by the Company through a provision for loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, "Receivables" and allowance allocations calculated in accordance with ASC Topic 450, "Contingencies." Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including, among other things, the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Company’s allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Bank and the Company; and (iv) unallocated allowance which represents the excess allowance not allocated to specific loans pools.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor’s ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has a calculated grade of 5 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower’s ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower’s industry, among other things.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Company calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. The Company’s pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Bank and the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the Bank’s lending management and staff; (ii) the effectiveness of the Bank’s loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the impact of competition on loan structuring and pricing; (vii) the effectiveness of the internal loan review function; (viii) the impact of environmental risks on portfolio risks; and (ix) the impact of rising interest rates on portfolio risk. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate or low degree of risk. The results are then input into a “general allocation matrix” to determine an appropriate general valuation allowance.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

Loans identified as losses by management, internal loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements.

The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2016 and 2015. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

Allowance for Loan Losses
For the Three and Nine Months Ended September 30, 2016 and 2015

(in thousands)	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Three Months Ended September 30, 2016							
Beginning balance	$ 6,133	$ 671	$ 55	$ 387	$ 431	$ 3	$ 7,680
Charge-offs	0	0	(5)	0	0	0	(5)
Recoveries	0	0	2		0	0	2
Provision for (reversal of) loan losses	(62)	60	(4)	(8)	63	41	90
Ending balance	$ 6,071	$ 731	$ 48	$ 379	$ 494	$ 44	$ 7,767
Nine Months Ended September 30, 2016							
Beginning balance	$ 5,920	$ 627	$ 38	$ 426	$ 309	$ 36	$ 7,356
Charge-offs	-	-	(12)	-	-	-	(12)
Recoveries	3	-	5		-	-	8
(Reversal of) provision for loan losses	148	104	17	(47)	185	8	415
Ending balance	$ 6,071	$ 731	$ 48	$ 379	$ 494	$ 44	$ 7,767

(in thousands)	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Three Months Ended September 30, 2015							
Beginning balance	$ 5,884	$ 583	$ 45	$ 480	$ 263	$ 135	$ 7,390
Charge-offs	0	0	(2)	0	0	0	(2)
Recoveries	1	0	0	0	0	0	1
Provision for (reversal of provision) loan losses	12	90	(2)	(14)	(15)	(71)	0
Ending balance	$ 5,897	$ 673	$ 41	$ 466	$ 248	$ 64	$ 7,389
Nine Months Ended September 30, 2015							
Beginning balance	$ 5,963	$ 720	$ 42	$ 388	$ 286	$ 135	$ 7,534
Charge-offs	0	0	(24)	0	0	0	(24)

Recoveries	2	0	2	0	0	0	4
(Reversal of) provision for loan losses	(68)	(47)	21	78	(38)	(71)	(125)
Ending balance	$ 5,897	$ 673	$ 41	$ 466	$ 248	$ 64	$ 7,389

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The following table details the allowance for loan losses and ending gross loan balances as of September 30, 2016, December 31, 2015 and September 30, 2015 summarized by collective and individual evaluation methods of impairment.

(in thousands) **September 30, 2016**	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer