Oak Valley Bancorp
Form 10-Q
August 14, 2015

**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 June 30, 2015**

**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<br>(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: 8,072,655 shares of common stock outstanding as of August 11, 2015.

**Oak Valley Bancorp**

**June 30, 2015**

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**PART I – FINANCIAL STATEMENTS**

**Item 1. Consolidated Financial Statements (Unaudited)**

**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

| (dollars in thousands) | June 30, 2015 | December 31, 2014 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | $126,899 | $132,078 |
| Federal funds sold | 15,115 | 12,210 |
| Cash and cash equivalents | 142,014 | 144,288 |
| | | |
| Securities available for sale | 127,897 | 121,277 |
| Loans, net of allowance for loan loss of $7,390 and $7,534 at June 30, 2015 and December 31, 2014, respectively | 455,674 | 446,492 |
| Bank premises and equipment, net | 13,715 | 14,066 |
| Other real estate owned | 834 | 884 |
| Interest receivable and other assets | 23,874 | 22,658 |
| | | |
| | $764,008 | $749,665 |
| | | |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| | | |
| Deposits | $683,937 | $669,581 |
| Interest payable and other liabilities | 3,906 | 5,043 |
| Total liabilities | 687,843 | 674,624 |
| | | |
| Commitments and contingencies | | |
| | | |
| Shareholders' equity | | |
| Preferred stock, 10,000,000 shares authorized, no shares issued and outstanding at June 30, 2015 and December 31, 2014 | 0 | 0 |
| Common stock, no par value; 50,000,000 shares authorized, 8,072,655 and 8,074,855 shares issued and outstanding at June 30, 2015 and December 31, 2014, respectively | 24,682 | 24,682 |
| Additional paid-in capital | 3,033 | 2,910 |
| Retained earnings | 47,810 | 45,582 |
| Accumulated other comprehensive income, net of tax | 640 | 1,867 |
| Total shareholders' equity | 76,165 | 75,041 |

| | | |
|---|---|---|
| | $764,008 | $749,665 |

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

**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

| (dollars in thousands, except per share amounts) | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | $5,376 | $5,343 | $10,779 | $10,648 |
| Interest on securities available for sale | 898 | 933 | 1,773 | 1,848 |
| Interest on federal funds sold | 9 | 10 | 17 | 24 |
| Interest on deposits with banks | 72 | 51 | 139 | 94 |
| Total interest income | 6,355 | 6,337 | 12,708 | 12,614 |
| INTEREST EXPENSE | | | | |
| Deposits | 155 | 162 | 307 | 335 |
| Total interest expense | 155 | 162 | 307 | 335 |
| Net interest income | 6,200 | 6,175 | 12,401 | 12,279 |
| (Reversal of) provision for loan losses | 0 | (1,877) | (125) | (1,877) |
| Net interest income after (reversal of) provision for loan losses | 6,200 | 8,052 | 12,526 | 14,156 |
| OTHER INCOME | | | | |
| Service charges on deposits | 308 | 336 | 620 | 645 |
| Earnings on cash surrender value of life insurance | 106 | 110 | 214 | 211 |
| Mortgage commissions | 42 | 49 | 88 | 78 |
| Net gain on sales and calls of securities | 73 | 4 | 182 | 12 |
| Other | 627 | 428 | 1,079 | 791 |
| Total non-interest income | 1,156 | 927 | 2,183 | 1,737 |
| OTHER EXPENSES | | | | |
| Salaries and employee benefits | 2,955 | 2,704 | 5,938 | 5,415 |
| Occupancy expenses | 724 | 713 | 1,471 | 1,458 |
| Data processing fees | 358 | 330 | 711 | 656 |
| Regulatory assessments (FDIC & DBO) | 131 | 120 | 245 | 240 |
| Other operating expenses | 1,025 | 1,122 | 1,926 | 2,101 |
| Total non-interest expense | 5,193 | 4,989 | 10,291 | 9,870 |
| Net income before provision for income taxes | 2,163 | 3,990 | 4,418 | 6,023 |
| PROVISION FOR INCOME TAXES | 653 | 1,453 | 1,382 | 2,078 |

| | | | | |
|---|---|---|---|---|
| NET INCOME | $1,510 | $2,537 | $3,036 | $3,945 |
| NET INCOME PER COMMON SHARE | $0.19 | $0.32 | $0.38 | $0.50 |
| NET INCOME PER DILUTED COMMON SHARE | $0.19 | $0.32 | $0.38 | $0.49 |

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

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**OAK VALLEY BANCORP**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

| | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| (in thousands) | 2015 | 2014 | 2015 | 2014 |
| Net income | $1,510 | $2,537 | $3,036 | $3,945 |
| Available for sale securities: | | | | |
| Unrealized holding (losses) gains on securities arising during the current period, net of tax effect of ($824) thousand and ($783) thousand for the three and six month periods ended June 30, 2015, respectively and $637 thousand and $1.3 million for the comparable 2014 periods | (1,178) | 911 | (1,120) | 1,791 |
| Reclassification adjustment due to net gains realized on sales and calls of securities, net of tax effect of $30 thousand and $75 thousand for the three and six months ended June 30, 2015, respectively and $2 thousand and $5 thousand for the comparable 2014 periods | (43) | (2) | (107) | (7) |
| Other comprehensive (loss) income | (1,221) | 909 | (1,227) | 1,784 |
| Comprehensive income | $289 | $3,446 | $1,809 | $5,729 |

*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, 2014 AND SIX MONTHS ENDED JUNE 30, 2015 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Common Stock | | Preferred Stock | | Additional Paid-in | Retained | Accumulated Other Comprehensive | Total Shareholders' |
| (dollars in thousands) | Shares | Amount | Shares | Amount | Capital | Earnings | Income (Loss) | Equity |
| Balances, January 1, 2014 | 7,929,730 | $23,758 | 0 | $ 0 | $ 2,537 | $38,985 | $ (763) | $ 64,517 |
| Stock options exercised | 122,625 | 924 | | | | | | 924 |
| Tax benefit on stock based compensation | | | | | 102 | | | 102 |
| Restricted stock issued | 24,500 | | | | | | | |
| Restricted stock forfeited | (2,000) | | | | | | | |
| Cash dividends declared | | | | | | (525) | | (525) |
| Stock based compensation | | | | | 271 | | | 271 |
| Other comprehensive income | | | | | | | 2,630 | 2,630 |
| Net income | | | | | | 7,122 | | 7,122 |
| Balances, December 31, 2014 | 8,074,855 | $24,682 | 0 | $ 0 | $ 2,910 | $45,582 | $ 1,867 | $ 75,041 |
| Restricted stock issued | 500 | | | | | | | |
| Restricted stock forfeited | (2,700) | | | | | | | |
| Cash dividends declared | | | | | | (808) | | (808) |
| Stock based compensation | | | | | 123 | | | 123 |
| Other comprehensive loss | | | | | | | (1,227) | (1,227) |
| Net income | | | | | | 3,036 | | 3,036 |
| Balances, June 30, 2015 | 8,072,655 | $24,682 | 0 | $ 0 | $ 3,033 | $47,810 | $ 640 | $ 76,165 |

*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) | SIX MONTHS ENDED JUNE 30, 2015 | 2014 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $3,036 | $3,945 |
| Adjustments to reconcile net earnings to net cash from operating activities: | | |
| (Reversal of) provision for loan losses | (125) | (1,877) |
| Decrease in deferred fees/costs, net | (46) | (209) |
| Depreciation | 588 | 299 |
| Amortization of investment securities, net | 87 | 85 |
| Stock based compensation | 123 | 147 |
| Excess tax benefits from exercised stock options | 0 | (52) |
| Gain on sale of premises and equipment | (5) | (3) |
| OREO write downs | 50 | 17 |
| Gain on sales and calls of available for sale securities | (182) | (12) |
| Earnings on cash surrender value of life insurance | (214) | (211) |
| Gain on BOLI death benefit | (66) | 0 |
| (Decrease) increase in interest payable and other liabilities | (1,137) | 63 |
| (Increase) decrease in interest receivable | (111) | 81 |
| (Increase) decrease in other assets | (260) | 190 |
| Net cash from operating activities | 1,738 | 2,463 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of available for sale securities | (25,084) | (14,149) |
| Proceeds from maturities, calls, and principal paydowns of securities available for sale | 16,475 | 10,373 |
| Net increase in loans | (9,011) | (14,413) |
| Purchase of FHLB Stock | 0 | (104) |
| Purchase of BOLI policies | 0 | (1,029) |
| Proceeds from redemption of BOLI policies | 292 | 0 |
| Proceeds from sales of premises and equipment | 5 | 3 |
| Net purchases of premises and equipment | (237) | (375) |
| Net cash used in investing activities | (17,560) | (19,694) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Shareholder cash dividends paid | (808) | (793) |
| Net increase in demand deposits and savings accounts | 15,841 | 1,796 |
| Net decrease in time deposits | (1,485) | (1,451) |
| Excess tax benefits from exercised stock options | 0 | 52 |
| Proceeds from sale of common stock and exercise of stock options | 0 | 924 |

| | | |
|---|---|---|
| Net cash from financing activities | 13,548 | 528 |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (2,274 ) | (16,703 ) |
| CASH AND CASH EQUIVALENTS, beginning of period | 144,288 | 105,191 |
| CASH AND CASH EQUIVALENTS, end of period | $142,014 | $88,488 |
| | | |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for: | | |
| Interest | $318 | $357 |
| Income taxes | $1,940 | $2,075 |
| | | |
| NON-CASH INVESTING ACTIVITIES: | | |
| Change in unrealized (loss) gain on available-for-sale securities | $(2,085 ) | $3,030 |

*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**

Oak Valley Community Bank is a California State chartered bank. The Company 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.

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

The consolidated financial statements include the accounts of Bancorp 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 six month periods ended June 30, 2015 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, 2014.

**NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS**

In January 2014, the FASB issued ASU No. 2014 – 01, *Investments – Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects.* This Update provides guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. The adoption of ASU No. 2014-01 did not have a material impact on the Company's consolidated financial statements.

In January 2014, the FASB issued ASU No. 2014 – 04, *Receivables – Troubled Debt Restructurings by Creditors*. This ASU provides clarification that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of ASU No. 2014-04 did not have a material impact on the Company's consolidated financial statements.

In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-14 *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40), Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure.* This update addresses classification of government-guaranteed mortgage loans, including those where guarantees are offered by the Federal Housing Administration ("FHA"), the U.S. Department of Housing and Urban Development ("HUD"), and the U.S. Department of Veterans Affairs ("VA"). Although current accounting guidance stipulates proper measurement and classification in situations where a creditor obtains from a debtor, assets in satisfaction of a receivable (such as through foreclosure), current guidance does not specify how to measure and classify foreclosed mortgage loans that are government-guaranteed. Under the provisions of this update, a creditor would derecognize a mortgage loan that has been foreclosed upon, and recognize a separate receivable if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure, (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 that claim, (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. The amendments within this update are effective for annual and interim periods beginning after December 15, 2014. The adoption of ASU No. 2014-14 did not have a material impact on the Company's consolidated financial statements.

**NOTE 3 – SECURITIES**

The amortized cost and estimated fair values of debt securities as of June 30, 2015 are as follows:

| (dollars in thousands) | **Amortized Cost** | **Gross Unrealized Gains** | **Gross Unrealized Losses** | **Fair Value** |
|---|---|---|---|---|
| Available-for-sale securities: | | | | |
| U.S. agencies | $ 38,504 | $ 1,338 | $ (219 ) | $ 39,623 |
| Collateralized mortgage obligations | 4,162 | 43 | (26 ) | 4,179 |
| Municipalities | 60,390 | 1,247 | (1,190 ) | 60,447 |
| SBA pools | 870 | 0 | (1 ) | 869 |
| Corporate debt | 8,485 | 72 | (19 ) | 8,538 |
| Asset backed securities | 11,272 | 33 | (55 ) | 11,250 |
| Mutual fund | 3,125 | 0 | (134 ) | 2,991 |
| | $ 126,808 | $ 2,733 | $ (1,644 ) | $ 127,897 |

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 June 30, 2015.

| (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 | $5,849 | $ (71) | $4,735 | $ (148) | $10,584 | $ (219) |
| Collateralized mortgage obligations | 52 | (1) | 1,361 | (26) | 1,413 | (26) |
| Municipalities | 34,767 | (955) | 3,130 | (235) | 37,897 | (1,190) |
| SBA pools | 0 | 0 | 869 | (1) | 869 | (1) |
| Corporate debt | 2,154 | (19) | 0 | 0 | 2,154 | (19) |
| Asset backed securities | 2,979 | (13) | 4,841 | (42) | 7,820 | (55) |
| Mutual fund | 0 | 0 | 2,991 | (134) | 2,991 | (134) |
| Total temporarily impaired securities | $45,801 | $ (1,059) | $17,927 | $ (586) | $63,728 | $ (1,644) |

At June 30, 2015, there were three U.S. agencies, one collateralized mortgage obligations, five municipalities, two SBA pools, three asset backed securities and one mutual fund that comprised the total securities in an unrealized loss position for greater than 12 months and 3 U.S. agencies, one collateralized mortgage obligation, 36 municipalities, two corporate debts and one asset backed security 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 June 30, 2015, 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 | $ 13,916 | $ 14,178 |
| Due after one year through five years | 30,227 | 31,363 |
| Due after five years through ten years | 47,519 | 46,901 |
| Due after ten years | 35,146 | 35,455 |
| | $ 126,808 | $ 127,897 |

The amortized cost and estimated fair values of investment securities as of December 31, 2014, are as follows:

| (dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Available-for-sale securities: | | | | |
| U.S. agencies | $ 40,316 | $ 1,760 | $ (146 ) | $ 41,930 |
| Collateralized mortgage obligations | 6,927 | 184 | (39 ) | 7,072 |
| Municipalities | 49,396 | 1,713 | (212 ) | 50,897 |
| SBA pools | 895 | 0 | (3 ) | 892 |
| Corporate debt | 6,726 | 95 | (17 ) | 6,804 |
| Asset backed securities | 10,766 | 50 | (106 ) | 10,710 |
| Mutual fund | 3,077 | 0 | (105 ) | 2,972 |
| | $ 118,103 | $ 3,802 | $ (628 ) | $ 121,277 |

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, 2014.

| (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 | $ 0 | $ 0 | $ 8,446 | $ (146 ) | $ 8,446 | $ (146 ) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Collateralized mortgage obligations | 0 | 0 | 1,445 | (39) | 1,445 | (39) |
| Municipalities | 3,530 | (22) | 12,791 | (190) | 16,321 | (212) |
| SBA pools | 0 | 0 | 892 | (3) | 892 | (3) |
| Corporate debt | 1,983 | (17) | 0 | 0 | 1,983 | (17) |
| Asset backed securities | 3,798 | (79) | 971 | (27) | 4,769 | (106) |
| Mutual fund | 0 | 0 | 2,972 | (105) | 2,972 | (105) |
| Total temporarily impaired securities | $9,311 | $ (118) | $27,517 | $ (510) | $36,828 | $ (628) |

We recognized a gain of $73,000 and $182,000 for the three and six month periods ended June 30, 2015, respectively, on certain available-for-sale securities that were called or sold, which compares to $4,000 and $12,000 in the same periods of 2014. The gains in 2015 reflected in the condensed consolidated statements of income are net of $19,000 in gross realized losses related to two available-for-sale securities sold during the first quarter of 2015, compared to no sales of securities resulting in losses during the first six months of 2014.

Securities carried at $64,955,000 and $60,474,000 at June 30, 2015 and December 31, 2014, respectively, were pledged to secure deposits of public funds.

**NOTE 4 – LOANS**

Our customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of June 30, 2015, approximately 83% of the Company's loans are commercial real estate loans which include construction loans. Approximately 9% of the Company's loans are for general commercial uses including professional, retail, and small business. Additionally, 5% of the Company's loans are for residential real estate and other consumer loans. The remaining 3% are agriculture loans. Loan totals were as follows:

| (in thousands) | June 30, 2015 | December 31, 2014 |
|---|---|---|
| Commercial real estate: | | |
| Commercial real estate- construction | $18,425 | $9,181 |
| Commercial real estate- mortgages | 330,542 | 315,506 |
| Land | 8,941 | 10,620 |
| Farmland | 28,065 | 23,091 |
| Commercial and industrial | 43,762 | 54,051 |
| Consumer | 787 | 805 |
| Consumer residential | 20,173 | 25,464 |
| Agriculture | 12,768 | 15,753 |
| Total loans | 463,463 | 454,471 |
| | | |
| Less: | | |
| Deferred loan fees and costs, net | (399) | (445) |
| Allowance for loan losses | (7,390) | (7,534) |
| Net loans | $455,674 | $446,492 |

*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 June 30, 2015, commercial real estate loans equal to approximately 39.1% 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.

*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) | June 30, 2015 | December 31, 2014 |
|---|---|---|
| Commercial real estate: | | |
| Commercial real estate- construction | $0 | $ 0 |
| Commercial real estate- mortgages | 0 | 1,296 |
| Land | 2,944 | 2,995 |
| Farmland | 62 | 72 |
| Commercial and industrial | 1,357 | 337 |
| Total non-accrual loans | $4,363 | $ 4,700 |

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income of approximately $71,000 and $153,000 in the three and six month periods ended June 30, 2015, as compared to $59,000 and $190,000 in the same periods of 2014.

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of June 30, 2015 (in thousands):

| **June 30, 2015** | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days Past Due | Total Past Due | Current | Total | Greater Than 90 Days Past Due and Still Accruing |
|---|---|---|---|---|---|---|---|
| Commercial real estate: | | | | | | | |
| Commercial R.E. - construction | $ 0 | $ 0 | $0 | $0 | $18,425 | $18,425 | $ 0 |
| Commercial R.E. - mortgages | 0 | 0 | 0 | 0 | 330,542 | 330,542 | 0 |
| Land | 0 | 0 | 2,452 | 2,452 | 6,489 | 8,941 | 0 |
| Farmland | 0 | 0 | 62 | 62 | 28,003 | 28,065 | 0 |
| Commercial and industrial | 0 | 0 | 1,346 | 1,346 | 42,416 | 43,762 | 0 |
| Consumer | 0 | 0 | 0 | 0 | 787 | 787 | 0 |
| Consumer residential | 0 | 0 | 0 | 0 | 20,173 | 20,173 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 12,768 | 12,768 | 0 |
| Total | $ 0 | $ 0 | $3,860 | $3,860 | $459,603 | $463,463 | $ 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, 2014 (in thousands):

| **December 31, 2014** | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days Past Due | Total Past Due | Current | Total | Greater Than 90 Days Past Due and Still Accruing |
|---|---|---|---|---|---|---|---|
| Commercial real estate: | | | | | | | |
| Commercial R.E. - construction | $ 0 | $0 | $0 | $0 | $9,181 | $9,181 | $ 0 |
| Commercial R.E. - mortgages | 35 | 1,296 | 0 | 1,331 | 314,175 | 315,506 | 0 |
| Land | 0 | 0 | 2,493 | 2,493 | 8,127 | 10,620 | 0 |
| Farmland | 0 | 0 | 72 | 72 | 23,019 | 23,091 | 0 |
| Commercial and industrial | 14 | 0 | 323 | 337 | 53,714 | 54,051 | 0 |
| Consumer | 0 | 0 | 0 | 0 | 805 | 805 | 0 |
| Consumer residential | 0 | 0 | 0 | 0 | 25,464 | 25,464 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 15,753 | 15,753 | 0 |
| Total | $ 49 | $1,296 | $2,888 | $4,233 | $450,238 | $454,471 | $ 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 and six months ended June 30, 2015 and 2014. Average recorded investment in impaired loans was $4.38 million and $4.47 million for the three and six months ended June 30, 2015, as compared to $4.71 million and $4.25 million for the same periods of 2014. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Impaired loans as of June 30, 2015 and December 31, 2014 are set forth in the following table.

| (in thousands) | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment |
|---|---|---|---|---|---|---|
| **June 30, 2015** | | | | | | |
| Commercial real estate: | | | | | | |
| Commercial R.E. - mortgages | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 | $ 324 |
| Land | 3,215 | 0 | 2,944 | 2,944 | 854 | 2,976 |
| Farmland | 72 | 62 | 0 | 62 | 0 | 67 |
| Commercial and Industrial | 1,386 | 329 | 1,028 | 1,357 | 95 | 1,105 |
| Total | $ 4,674 | $ 391 | $ 3,972 | $ 4,363 | $ 949 | $ 4,472 |
| | | | | | | |
| **December 31, 2014** | | | | | | |
| Commercial real estate: | | | | | | |
| Commercial R.E. - mortgages | $ 1,301 | $ 0 | $ 1,296 | $ 1,296 | $ 125 | $ 554 |
| Land | 3,215 | 0 | 2,995 | 2,995 | 868 | 3,155 |
| Farmland | 80 | 72 | 0 | 72 | 0 | 82 |
| Commercial and Industrial | 359 | 337 | 0 | 337 | 0 | 304 |
| Total | $ 4,956 | $ 408 | $ 4,291 | $ 4,700 | $ 993 | $ 4,096 |

*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 June 30, 2015, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $3,272,000. At December 31, 2014, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $3,332,000. At June 30, 2015 and December 31, 2014 there were no unfunded commitments on loans classified as a troubled debt restructures. We have allocated $854,000 and $868,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of June 30, 2015 and December 31, 2014, 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 three and six month periods ended June 30, 2015, the terms of two loans were modified as troubled debt restructurings by extending the maturity dates.

The following tables presents loans by class modified as troubled debt restructurings that occurred during the three and six month periods ended June 30, 2015 and 2014:

| (dollars in thousands) | Three Months Ended June 30, 2015 | | | Three Months Ended June 30, 2014 | | |
|---|---|---|---|---|---|---|
| | 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 | 570 | 570 | 2 | 2,565 | 2,565 |
| Farmland | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial and industrial | 1 | 24 | 24 | 1 | 331 | 331 |
| Consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Consumer residential | 0 | 0 | 0 | 0 | 0 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | 2 | $ 594 | $ 594 | 3 | $ 2,896 | $ 2,896 |

| (dollars in thousands) | Six Months Ended June 30, 2015 | | | Six Months Ended June 30, 2014 | | |
|---|---|---|---|---|---|---|
| | 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 | 570 | 570 | 3 | 3,107 | 3,107 |
| Farmland | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial and industrial | 1 | 24 | 24 | 1 | 331 | 331 |
| Consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| Consumer residential | 0 | 0 | 0 | 0 | 0 | 0 |
| Agriculture | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | 2 | $ 594 | $ 594 | 4 | $ 3,438 | $ 3,438 |

The troubled debt restructuring during the three and six months ended June 30, 2015 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 six month periods ended June 30, 2015, compared to one commercial real estate land loan with a balance of $54,000 that was modified and defaulted during the six month period of 2014. There were no such payment defaults on modified loans during the three months ended June 30, 2014. A loan is considered to be in payment default once it is ninety days contractually past due under the modified terms.

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 June 30, 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:

| | June 30, 2015 Weighted Average Risk Grade | December 31, 2014 Weighted Average Risk Grade |
|---|---|---|
| Commercial real estate: | | |
| Commercial real estate - construction | 3.36 | 3.00 |
| Commercial real estate - mortgages | 3.12 | 3.15 |
| Land | 4.41 | 4.34 |
| Farmland | 3.01 | 3.01 |
| Commercial and industrial | 3.35 | 3.39 |
| Consumer | 2.12 | 2.11 |
| Consumer residential | 3.01 | 3.02 |
| Agriculture | 3.22 | 3.18 |
| Total gross loans | 3.16 | 3.19 |

The following table presents risk grade totals by class of loans as of June 30, 2015 and December 31, 2014. 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 |
|---|---|---|---|---|---|---|---|---|---|
| June 30, 2015 | | | | | | | | | |
| Pass | $ 18,425 | $ 329,909 | $ 5,997 | $ 28,003 | $ 42,243 | $ 757 | $ 20,124 | $ 12,768 | $ 458,226 |
| Special mention | - | 425 | - | - | - | - | - | - | 425 |
| Substandard | - | 208 | 2,944 | 62 | 1,519 | 30 | 49 | - | 4,812 |
| Doubtful | - | - | - | - | - | - | - | - | - |
| Total loans | $ 18,425 | $ 330,542 | $ 8,941 | $ 28,065 | $ 43,762 | $ 787 | $ 20,173 | $ 12,768 | $ 463,463 |
| December 31, 2014 | | | | | | | | | |
| Pass | $ 9,181 | $ 310,912 | $ 7,625 | $ 23,019 | $ 48,997 | $ 790 | $ 25,283 | $ 15,753 | $ 441,560 |
| Special mention | - | 2,722 | - | - | 3,438 | - | - | - | 6,160 |
| Substandard | - | 1,872 | 2,995 | 72 | 1,616 | 15 | 181 | - | 6,751 |
| Doubtful | - | - | - | - | - | - | - | - | - |
| Total loans | $ 9,181 | $ 315,506 | $ 10,620 | $ 23,091 | $ 54,051 | $ 805 | $ 25,464 | $ 15,753 | $ 454,471 |

*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; and (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.

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 six months ended June 30, 2015 and 2014. 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 Six Months Ended June 30, 2015 and 2014**

| (in thousands) | Commercial Real Estate | Commercial and Industrial | Consumer | Consumer Residential | Agriculture | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| **Three Months Ended June 30, 2015** | | | | | | | |
| Beginning balance | $ 5,810 | $ 685 | $ 50 | $ 555 | $ 181 | $ 128 | $7,409 |
| Charge-offs | 0 | 0 | (21 ) | 0 | 0 | 0 | (21 ) |
| Recoveries | 1 | 0 | 1 | 0 | 0 | 0 | 2 |
| Provision for (reversal of provision) loan losses | 73 | (102 ) | 15 | (75 ) | 82 | 7 | 0 |
| Ending balance | $ 5,884 | $ 583 | $ 45 | $ 480 | $ 263 | $ 135 | $7,390 |
| **Six Months Ended June 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 | 3 | 0 | 0 | 0 | 5 |
| (Reversal of) provision for loan losses | (81 ) | (137 ) | 24 | 92 | (23 ) | 0 | (125 ) |
| Ending balance | $ 5,884 | $ 583 | $ 45 | $ 480 | $ 263 | $ 135 | $7,390 |
| **Three Months Ended June 30, 2014** | | | | | | | |
| Beginning balance | $ 6,192 | $ 742 | $ 45 | $ 417 | $ 215 | $ 4 | $7,615 |
| Charge-offs | 0 | 0 | (15 ) | 0 | 0 | 0 | (15 ) |
| Recoveries | 1,877 | 0 | 0 | 2 | 0 | 0 | 1,879 |
| (Reversal of) provision for loan losses | (1,813 ) | (182 ) | 21 | 11 | 46 | 40 | (1,877) |
| Ending balance | $ 6,256 | $ 560 | $ 51 | $ 430 | $ 261 | $ 44 | $7,602 |
| **Six Months Ended June 30, 2014** | | | | | | | |
| Beginning balance | $ 6,247 | $ 663 | $ 47 | $ 440 | 217 | $ 45 | $7,659 |
| Charge-offs | (50 ) | 0 | (18 ) | 0 | 0 | 0 | (68 ) |
| Recoveries | 1,877 | 0 | 1 | 10 | 0 | 0 | 1,888 |
| (Reversal of) provision for loan losses | (1,818 ) | (103 ) | 21 | (20 ) | 44 | (1 ) | (1,877) |
| Ending balance | $ 6,256 | $ 560 | $ 51 | $ 430 | $ 261 | $ 44 | $7,602 |

The following table details the allowance for loan losses and ending gross loan balances as of June 30, 2015, December 31, 2014 and June 30, 2014 summarized by collective and individual evaluation methods of impairment.

(in thousands)

| **June 30, 2015** | Commercial Real Estate | Commercial and Industrial | Consumer | Consumer Residential | Agriculture | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| Allowance for loan losses for loans: | | | | | | | |
| Individually evaluated for impairment | $ 854 | $ 95 | $ 0 | $ 0 | $ 0 | $ 0 | $ 949 |
| Collectively evaluated for impairment | 5,030 | 488 | 45 | 480 | 263 | 135 | 6,441 |
| | $ 5,884 | $ 583 | $ 45 | $ 480 | $ 263 | $ 135 | $ 7,390 |
| Ending gross loan balances: | | | | | | | |
| Individually evaluated for impairment | $ 3,006 | $ 1,357 | $ 0 | $ 0 | $ 0 | $ 0 | $ 4,363 |
| Collectively evaluated for impairment | 382,967 | 42,405 | 787 | 20,173 | 12,768 | 0 | 459,100 |
| | $ 385,973 | $ 43,762 | $ 787 | $ 20,173 | $ 12,768 | $ 0 | $ 463,463 |
| **December 31, 2014** | | | | | | | |
| Allowance for loan losses for loans: | | | | | | | |
| Individually evaluated for impairment | $ 993 | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 | $ 993 |
| Collectively evaluated for impairment | 4,970 | 720 | 42 | 388 | 286 | 135 | 6,541 |
| | $ 5,963 | $ 720 | $ 42 | $ 388 | $ 286 | $ 135 | $ 7,534 |
| Ending balances of loans: | | | | | | | |
| Individually evaluated for impairment | $ 4,363 | $ 337 | $ 0 | $ 0 | $ 0 | $ 0 | $ 4,700 |
| Collectively evaluated for impairment | 354,035 | 53,714 | 805 | 25,464 | 15,753 | 0 | 449,771 |
| | $ 358,398 | $ 54,051 | $ 805 | $ 25,464 | $ 15,753 | $ 0 | $ 454,471 |
| **June 30, 2014** | | | | | | | |
| Allowance for loan losses for loans: | | | | | | | |
| Individually evaluated for impairment | $ 1,068 | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 | $ 1,068 |
| Collectively evaluated for impairment | 5,188 | 560 | 51 | 430 | 261 | 44 | 6,534 |
| | $ 6,256 | $ 560 | $ 51 | $ 430 | $ 261 | $ 44 | $ 7,602 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Ending gross loan balances: | | | | | | | |
| Individually evaluated for impairment | $ 3,818 | $ 348 | $ 0 | $ 0 | $ 0 | $ 0 | $4,166 |
| Collectively evaluated for impairment | 352,327 | 38,467 | 843 | 25,542 | 14,326 | 0 | 431,505 |
| | $ 356,145 | $ 38,815 | $ 843 | $ 25,542 | $ 14,326 | $ 0 | $435,671 |

Changes in the reserve for off-balance-sheet commitments were as follows:

| | THREE MONTHS ENDED JUNE 30, | | SIX MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| | **2015** | **2014** | **2015** | **2014** |
| Balance, beginning of period | $227 | $131 | $218 | $134 |
| Provision (Recovery) to Operations for Off Balance Sheet Commitments | 7 | 17 | 16 | 14 |
| Balance, end of period | $234 | $148 | $234 | $148 |

The method for calculating the reserve for off-balance-sheet loan commitments is based on a reserve percentage which is less than other outstanding loan types because they are at a lower risk level. This reserve percentage, based on many factors including historical losses and existing economic conditions, is evaluated by management periodically and is applied to the total undisbursed loan commitment balance to calculate the reserve for off-balance-sheet commitments. Reserves for off-balance-sheet commitments are recorded in interest payable and other liabilities on the condensed consolidated balance sheets.

At June 30, 2015 and December 31, 2014, loans carried at $463,463,000 and $454,471,000, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.

**NOTE 5 – OTHER REAL ESTATE OWNED**

As of June 30, 2015 and December 31, 2014, the Company owned three properties classified as other real estate with outstanding balances of $834,000 and $884,000, respectively, which includes one property consisting of residential land that was written down to a zero balance. Each of these properties was acquired through loan foreclosure. The residential land property the Company owned at June 30, 2015 and December 31, 2014, was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. There were no sales of OREO property during the six months ended June 30, 2015 and 2014.

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at the lower of carrying amount of the loan or fair value of the property at the date of foreclosure less selling costs. Subsequent to foreclosure, valuations are periodically performed and any subject revisions in the estimate of fair value are reported as adjustment to the carrying value of the real estate, provided the adjusted carrying amount does not exceed the original amount at foreclosure.  Revenues and expenses from operations and changes in the valuation allowance are included in other operating expenses.

**NOTE 6– OTHER POST-RETIREMENT BENEFIT PLANS**

During January 2008, the Bank awarded certain officers a salary continuation plan (the “Plan”). Under the Plan, the participants will be provided with a fixed annual retirement benefit for twenty years after retirement. The Bank is also responsible for certain pre-retirement death benefits under the Plan. In connection with the implementation of the Plan, the Bank purchased single premium life insurance policies on the life of each of the officers covered under the Plan. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the Plan, under Internal Revenue Service regulations, are owned by the Bank and are available to satisfy the Company’s general creditors.

The Bank awarded a director retirement plan (“DRP”) to two of its directors in January 2008 and to three of its newest directors in March 2014. Under the DRP, the participants will be provided with a fixed annual retirement benefit for ten years after retirement. The Bank is also responsible for certain pre-retirement death benefits under the DRP. In connection with the implementation of the DRP, the Bank purchased single premium life insurance policies on the life of each director covered under the DRP. The Bank is the owner and partial beneficiary of these life insurance policies. The assets of the DRP, under Internal Revenue Service regulations, are the property of the Bank and are available to satisfy the Bank’s general creditors.

Future compensation under both plans is earned for services rendered through retirement. The Bank accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Bank’s current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 20 years. The salary continuation liability as of June 30, 2015 and December 31, 2014 was $2,328,000 and $2,222,000, respectively, and is reported in interest payable and other liabilities on the condensed consolidated balance sheets.

During January 2008, the Bank purchased $4.7 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with certain officers and directors. During March 2014, the Bank purchased an additional $1.0 million in bank owned life insurance policies and entered into split-dollar life insurance agreements with its three newest directors. In connection with the implementation of the split-dollar agreements, the Bank purchased single premium life insurance policies on the life of each of the officers and directors covered by the split-dollar life insurance agreements. The Bank is the owner of the policies and the partial beneficiary in an amount equal to the cash surrender value of the policies.

The combined cash surrender value of all Bank-owned life insurance policies recorded in interest receivable and other assets on the condensed consolidated balance sheets were $13,532,000 and $13,549,000 at June 30, 2015 and December 31, 2014, respectively.

**NOTE 7 — FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS**

**Fair values of financial instruments —** The consolidated financial statements include various estimated fair value information as of June 30, 2015 and December 31, 2014. Such information, which pertains to the Company's financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change.

Fair value measurements defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

Level 1: Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally corresponds with the Company's quarterly valuation process. There were no transfers between levels during the three and six month periods ended June 30, 2015 or 2014.

Following is a description of valuation methodologies used for assets and liabilities in the tables below:

*Cash and cash equivalents* – The carrying amounts of cash and cash equivalents approximate their fair value and are considered a level 1 valuation.

*Restricted Equity Securities-* The carrying amounts of the stock the Company's owns in FRB and FHLB approximate their fair value and are considered a level 2 valuation.

*Loans receivable* — For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., real estate construction and mortgage, commercial, and installment loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks. The Company's fair value model takes into account many inputs including current market rates on new loans, the U.S. treasury yield curve, LIBOR yield curve, rate floors, rate ceilings, remaining maturity, and average life based on specific loan type. Net loans are considered to be a level 3 valuation.

*Deposit liabilities* — The fair values estimated for demand deposits (interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). The carrying amounts for variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of the aggregate expected monthly maturities on time deposits. The fair value of deposits is determined by the Company's internal assets and liabilities modeling system that accounts for various inputs such as decay rates, rate floors, FHLB yield curve, maturities and current rates offered on new accounts. Fair value on deposits is considered a level 3 valuation.

*Interest receivable and payable -* The carrying amounts of accrued interest approximate their fair value and are considered to be a level 2 valuation.

*Off-balance-sheet instruments* — Fair values for the Bank's off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the counterparties. The Company considers the Bank's off balance sheet instruments to be a level 3 valuation.

The estimated fair values of the Company's financial instruments at June 30, 2015 were as follows:

| (in thousands) | **Carrying Amount** | **Fair Value** | **Hierarchy Valuation Level** |
|---|---|---|---|
| **Financial assets:** | | | |
| Cash and cash equivalents | $142,014 | $142,014 | 1 |
| Restricted equity securities | 3,417 | 3,417 | 2 |
| Loans, net | 455,674 | 464,039 | 3 |
| Interest receivable | 2,135 | 2,135 | 2 |
| **Financial liabilities:** | | | |
| Deposits | (683,937) | (607,551) | 3 |
| Interest payable | (28) | (28) | 2 |
| **Off-balance-sheet assets (liabilities):** | | | |
| Commitments and standby letters of credit | | (903) | 3 |

The estimated fair values of the Company's financial instruments at December 31, 2014 were as follows:

| (in thousands) | **Carrying Amount** | **Fair Value** | **Hierarchy Valuation Level** |
|---|---|---|---|
| **Financial assets:** | | | |
| Cash and cash equivalents | $144,288 | $144,288 | 1 |
| Restricted equity securities | 3,275 | 3,275 | 2 |
| Loans, net | 446,492 | 455,501 | 3 |
| Interest receivable | 2,024 | 2,024 | 2 |
| **Financial liabilities:** | | | |
| Deposits | (669,581) | (600,941) | 3 |
| Interest payable | (39) | (39) | 2 |
| **Off-balance-sheet assets (liabilities):** | | | |
| Commitments and standby letters of credit | | (848) | 3 |

The following table presents the carrying value of recurring and nonrecurring financial instruments that were measured at fair value and that were still held in the condensed consolidated balance sheets at each respective period end, by level within the fair value hierarchy as of June 30, 2015 and December 31, 2014.

| | **Fair Value Measurements at June 30, 2015 Using** | | | |
|---|---|---|---|---|
| (in thousands) | **June 30, 2015** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| Assets and liabilities measured on a recurring basis: | | | | |
| Available-for-sale securities: | | | | |
| U.S. agencies | $39,623 | $ 0 | $ 39,623 | $ 0 |
| Collateralized mortgage obligations | 4,179 | 0 | 4,179 | 0 |
| Municipalities | 60,447 | 0 | 60,447 | 0 |
| SBA pools | 869 | 0 | 869 | 0 |
| Corporate debt | 8,538 | 0 | 8,538 | 0 |
| Asset backed securities | 11,250 | 0 | 11,250 | |
| Mutual fund | 2,991 | 2,991 | 0 | 0 |

Assets and liabilities measured on a non-recurring basis: