Oak Valley Bancorp
Form 10-Q
November 09, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

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 every Interactive Data File required to be submitted 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, a smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer   Accelerated filer
Non-accelerated filer   Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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: 8,193,305 shares of common stock outstanding as of November 1, 2018.

Oak Valley Bancorp

September 30, 2018

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PART I – FINANCIAL STATEMENTS

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in thousands)	September 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$151,656	$142,968
Federal funds sold	11,185	6,205
Cash and cash equivalents	162,841	149,173
Securities - available for sale	205,238	179,248
Securities - equity investments	3,060	3,112
Loans, net of allowance for loan loss of $8,135 and $8,166 at September 30, 2018 and December 31, 2017, respectively	653,995	652,989
Cash surrender value of life insurance	18,898	18,517
Bank premises and equipment, net	15,114	14,478
Other real estate owned	0	253
Goodwill and other intangible assets, net	3,970	4,056
Interest receivable and other assets	12,689	13,026
	$1,075,805	$1,034,852
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Deposits	$974,424	$938,882
Interest payable and other liabilities	5,715	5,203
Total liabilities	980,139	944,085
Shareholders’ equity		
Common stock, no par value; 50,000,000 shares authorized, 8,194,255 and 8,098,605 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	25,422	24,773
Additional paid-in capital	3,244	3,576
Retained earnings	67,707	61,429
Accumulated other comprehensive (loss) income, net of tax	(707)	989
Total shareholders’ equity	95,666	90,767
	$1,075,805	$1,034,852

The accompanying notes are an integral part of these condensed 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,	
	2018	2017	2018	2017
INTEREST INCOME				
Interest and fees on loans	$8,149	$7,300	$23,348	$21,451
Interest on securities	1,463	1,138	4,108	3,314
Interest on federal funds sold	55	28	139	65
Interest on deposits with banks	707	428	1,873	1,100
Total interest income	10,374	8,894	29,468	25,930
INTEREST EXPENSE				
Deposits	430	274	1,080	773
Total interest expense	430	274	1,080	773
Net interest income	9,944	8,620	28,388	25,157
Provision for loan losses	0	70	0	105
Net interest income after provision for loan losses	9,944	8,550	28,388	25,052
OTHER INCOME				
Service charges on deposits	388	365	1,126	1,051
Debit card transaction fee income	308	276	890	818
Earnings on cash surrender value of life insurance	130	130	381	386
Mortgage commissions	29	28	94	127
Gains on sales and calls of securities	3	4	80	394
Gain on sale of OREO	0	211	193	211
Other	279	262	716	1,795
Total non-interest income	1,137	1,276	3,480	4,782
OTHER EXPENSES				
Salaries and employee benefits	4,088	3,534	12,183	10,603
Occupancy expenses	882	823	2,757	2,496
Data processing fees	428	399	1,270	1,154
Regulatory assessments (FDIC & DBO)	110	102	338	381
Other operating expenses	1,312	1,202	3,909	3,708
Total non-interest expense	6,820	6,060	20,457	18,342

Net income before provision for income taxes	4,261	3,766	11,411	11,492
Total provision for income taxes	1,096	1,298	2,853	3,987
Net Income	$3,165	$2,468	$8,558	$7,505
Net income per share	$0.39	$0.31	$1.06	$0.93
Net income per diluted share	$0.39	$0.31	$1.06	$0.93

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
(in thousands)	2018	2017	2018	2017
Net income	$3,165	$2,468	$8,558	$7,505
Other comprehensive income:				
Unrealized gains on securities:				
Unrealized holding (losses) gains arising during the period	(976)	39	(2,559)	3,069
Less: reclassification for net gains included in net income	(3)	(4)	(80)	(394)
Other comprehensive (loss) gain, before tax	(979)	35	(2,639)	2,675
Tax benefit (expense) related to items of other comprehensive income	289	(14)	780	(1,101)
Total other comprehensive (loss) gain	(690)	21	(1,859)	1,574
Comprehensive income	$2,475	$2,489	$6,699	$9,079

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

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OAK VALLEY BANCORP

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

	YEAR ENDED DECEMBER 31, 2017 AND NINE MONTHS ENDED SEPTEMBER 30, 2018					
	Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	Total Shareholders’
(dollars in thousands)	Shares	Amount	Capital	Earnings	Income (Loss)	Equity
Balances, January 1, 2017	8,088,455	$24,682	$ 3,473	$54,520	$ (225)	$ 82,450
Stock options exercised	9,000	91				91
Restricted stock issued	8,000					0
Restricted stock forfeited	(6,850)					0
Cash dividends declared				(2,022)		(2,022)
Stock based compensation			103			103
Other comprehensive income					1,051	1,051
DTA remeasurement reclassification				(163)	163	0
Net income				9,094		9,094
Balances, December 31, 2017	8,098,605	$24,773	$ 3,576	$61,429	$ 989	$ 90,767
Restricted stock issued	96,650					0
Restricted stock forfeited	(1,000)					0
Cash dividends declared				(2,117)		(2,117)
Stock based compensation			317			317
APIC reclassification		649	(649)			0
Other comprehensive loss					(1,859)	(1,859)
Reclassification from adoption of ASU 2016-01				(163)	163	0
Net income				8,558		8,558
Balances, September 30, 2018	8,194,255	$25,422	$ 3,244	$67,707	$ (707)	$ 95,666

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

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OAK VALLEY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(dollars in thousands)	NINE MONTHS ENDED SEPTEMBER 30, 2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$8,558	$7,505
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	0	105
(Decrease) increase in deferred fees/costs, net	(324)	40
Depreciation	914	847
Amortization of investment securities, net	817	624
Stock based compensation	317	78
Gain on sale of OREO property	(193)	(211)
Gain on sale of available for sale security	(70)	0
Earnings on cash surrender value of life insurance	(381)	(386)
Increase (decrease) in interest payable and other liabilities	512	(238)
(Increase) decrease in interest receivable	(10)	101
Decrease (Increase) in other assets	1,550	(1,535)
Net cash from operating activities	11,690	6,930
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available for sale securities	(46,068)	(41,542)
Purchases of equity securities	(63)	(61)
Proceeds from maturities, calls, and principal paydowns of securities available for sale	16,701	23,524
Gain on calls of available for sale securities	(10)	(394)
Net increase in loans	(682)	(25,952)
Purchase of FHLB Stock	(222)	(340)
Proceeds from sale of OREO	447	1,168
Purchases of premises and equipment	(1,550)	(207)
Net cash used in investing activities	(31,447)	(43,804)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Shareholder cash dividends paid	(2,117)	(2,022)
Net increase (decrease) in demand deposits and savings accounts	41,695	(8,381)
Net decrease in time deposits	(6,153)	(3,996)
Proceeds from sale of common stock and exercise of stock options	0	91
Net cash from (used in) financing activities	33,425	(14,308)

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	13,668	(51,182)
CASH AND CASH EQUIVALENTS, beginning of period	149,173	190,810
CASH AND CASH EQUIVALENTS, end of period	$ 162,841	$ 139,628

The accompanying notes are an integral part of these condensed 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 Company became the sole wholly-owned subsidiary of the holding company.

The consolidated financial statements include the accounts of the parent company and its wholly-owned bank subsidiary. Unless otherwise stated, the “Company” refers to the consolidated entity, Oak Valley Bancorp, while the “Bank” refers to Oak Valley Community Bank. 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 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, 2018 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, 2017.

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, Escalon, and Sacramento, 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 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, fair value measurements, and the determination, recognition and measurement of impaired loans. Actual results could differ from these estimates.

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU is a converged standard involving FASB and International Financial Reporting Standards that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount and at a time that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Subsequent updates related to Revenue from Contracts with Customers (Topic 606) are as follows:

August 2015 ASU No. 2015-14 - Deferral of the Effective Date, institutes a one-year deferral of the effective date of this amendment to annual reporting periods beginning after December 15, 2017. Early application is permitted only as of annual periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

March 2016 ASU No. 2016-08 - Principal versus Agent Considerations (Reporting Revenue Gross versus Net), clarifies the implementation guidance on principal versus agent considerations and on the use of indicators that assist an entity in determining whether it controls a specified good or service before it is transferred to the customer.

April 2016 ASU No. 2016-10 - Identifying Performance Obligations and Licensing, provides guidance in determining performance obligations in a contract with a customer and clarifies whether a promise to grant a license provides a right to access or the right to use intellectual property.

May 2016 ASU No. 2016-12 - Narrow Scope Improvements and Practical Expedients, gives further guidance on assessing collectability, presentation of sales taxes, noncash consideration, and completed contracts and contract modifications at transition.

Topic 606 was adopted by the Company on January 1, 2018 and did not have a material impact on the Company's consolidated financial statements. No additional disaggregated revenue disclosures are necessary because interest income sources are scoped out and there are no additional significant noninterest income sources to break out on the consolidated statement of income.

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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 was adopted by the Company on January 1, 2018 and impacted the Company’s financial statement disclosures but did not have a material impact on the Company’s 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 ASU is permitted. The Company has evaluated the impact to its balance sheet and

expects that the gross-up in its balance sheet from recording a right-of-use asset and a lease liability for each lease as a result of adopting this ASU will not be material.

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. While the Company has not quantified the impact of this ASU, it does expect changing from the current incurred loss model to an expected loss model will result in an earlier recognition of losses.

In February 2018, the FASB issued ASU 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. The ASU was issued to address certain stranded tax effects in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act of 2017. The ASU provides companies the option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change from the newly enacted corporate tax rate is recorded. The amount of the reclassification would be calculated on the basis of the difference between the historical and newly enacted tax rates for deferred tax liabilities and assets related to items within accumulated other comprehensive income. The ASU requires companies to disclose its accounting policy related to releasing income tax effects from accumulated other comprehensive income, whether it has elected to reclassify the stranded tax effects, and information about the other income tax effects that are reclassified. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods, therein, and early adoption is permitted for public business entities for which financial statements have not yet been issued. As of December 31, 2017, the Company adopted the ASU and made a reclassification adjustment from accumulated other comprehensive income to retained earnings on the Consolidated Statements of Shareholders' Equity, related to the stranded tax effects due to the change in the federal corporate tax rate applied on the unrealized gains (losses) on investments on a portfolio basis, to reflect the provisions of this ASU.

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NOTE 3 – SECURITIES

Equity Securities

The Company held equity securities with fair values of $3,060,000 and $3,112,000 at September 30, 2018 and December 31, 2017, respectively. There were no sales of equity securities during the three and nine months ended September 30, 2018. Consistent with ASU 2016-01, these securities are carried at fair value with the changes in fair value recognized in the consolidated statement of income. Accordingly, the Company recognized an unrealized loss of $28,000 and $115,000 during the three and nine months ended September 30, 2018.

Debit Securities

Debt securities have been classified in the financial statements as available for sale. The amortized cost and estimated fair values of debt securities as of September 30, 2018 are as follows:

(dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Available-for-sale securities:				
U.S. agencies	$ 43,781	$ 150	$ (642)	$43,289
Collateralized mortgage obligations	2,178	0	(75)	2,103
Municipalities	90,684	1,060	(715)	91,029
SBA pools	9,299	13	(65)	9,247
Corporate debt	21,426	133	(862)	20,697
Asset backed securities	38,873	158	(158)	38,873
	$ 206,241	$ 1,514	$ (2,517)	$205,238

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The following tables detail the gross unrealized losses and fair values of debt securities aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2018.

(dollars in thousands)	**Less than 12 months**		**12 months or more**		**Total**	
	Fair	**Unrealized**	**Fair**	**Unrealized**	**Fair**	**Unrealized**
Description of Securities	**Value**	**Loss**	**Value**	**Loss**	**Value**	**Loss**
U.S. agencies	$27,197	$ (386)	$7,810	$ (256)	$35,007	$ (642)
Collateralized mortgage obligations	405	(3)	1,698	(72)	2,103	(75)
Municipalities	34,596	(301)	17,191	(414)	51,787	(715)
SBA pools	6,915	(59)	604	(5)	7,519	(64)
Corporate debt	3,987	(74)	11,699	(789)	15,686	(863)
Asset backed securities	18,982	(151)	1,921	(7)	20,903	(158)
Total temporarily impaired securities	$92,082	$ (974)	$40,923	$ (1,543)	$133,005	$ (2,517)

At September 30, 2018, twenty-four municipalities, nine corporate debts, seven U.S. agencies, two Small Business Administration pools, two asset backed securities and two collateralized mortgage obligations make up the total debt securities in an unrealized loss position for greater than 12 months. At September 30, 2018, forty municipalities, twenty-one U.S. agencies, ten asset backed securities, five SBA pools, two collateralized mortgage obligations, and two corporate debts make up the total debt 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 the 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 the Company 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 debt securities at September 30, 2018, 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	$ 36,177	$ 36,059
Due after one year through five years	51,966	51,875
Due after five years through ten years	46,981	46,495
Due after ten years	71,117	70,809
	$ 206,241	$ 205,238

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The amortized cost and estimated fair values of debt securities as of December 31, 2017, are as follows:

(dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
U.S. agencies	$ 29,741	$ 374	$ (143)	$ 29,972
Collateralized mortgage obligations	2,628	1	(36)	2,593
Municipalities	91,201	2,174	(308)	93,067
SBA pools	11,818	46	(14)	11,850
Corporate debt	19,358	112	(681)	18,789
Asset backed securities	22,866	125	(14)	22,977
	$ 177,612	$ 2,832	$ (1,196)	$ 179,248

The following tables detail the gross unrealized losses and fair values of debt securities aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2017.

(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	$ 10,588	$ (46)	$ 5,437	$ (97)	$ 16,025	$ (143)
Collateralized mortgage obligations	1,090	(11)	921	(26)	2,011	(37)
Municipalities	28,779	(236)	5,611	(72)	34,390	(308)
SBA pools	1,998	(4)	703	(9)	2,701	(13)
Corporate debt	1,994	(6)	13,815	(675)	15,809	(681)
Asset backed securities	6,154	(13)	333	(1)	6,487	(14)
Total temporarily impaired securities	$ 50,603	$ (316)	$ 26,820	$ (880)	$ 77,423	$ (1,196)

The Company recognized gross gains of $3,000 and $10,000 for the three and nine month periods ended September 30, 2018, on certain available-for-sale securities that were called, which compares to $4,000 and $394,000 for the same periods during 2017. There was one sale of a municipal bond resulting in a gain of $70,000 during the first nine months of 2018, compared to no sales during the same period of 2017.

Debt securities carried at $111,168,000 and $109,158,000 at September 30, 2018 and December 31, 2017, respectively, were pledged to secure deposits of public funds.

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NOTE 4 – LOANS

The Company’s customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of September 30, 2018, approximately 77% of the Company’s loans are commercial real estate loans which include construction loans. Approximately 12% 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 6% are agriculture loans. Loan totals were as follows:

(in thousands)	September 30, 2018	December 31, 2017
Commercial real estate:		
Commercial real estate- construction	$ 17,785	$ 31,265
Commercial real estate- mortgages	419,690	417,138
Land	10,062	10,072
Farmland	60,866	58,675
Commercial and industrial	80,932	69,610
Consumer	1,056	689
Consumer residential	35,765	37,161
Agriculture	37,039	37,934
Total loans	663,195	662,544
Less:		
Deferred loan fees and costs, net	(1,065)	(1,389)
Allowance for loan losses	(8,135)	(8,166)
Net loans	$ 653,995	$ 652,989

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, the Company’s 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, 2018 and December 31, 2017, commercial real estate loans equal to approximately 44% and 43%, respectively, of the outstanding principal balance of commercial real estate loans were secured by owner-occupied properties.

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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)	September 30, 2018	December 31, 2017
Commercial real estate:		
Land	$ 906	$ 993
Commercial and industrial	0	302
Consumer residential	14	16
Total non-accrual loans	$ 920	$ 1,311

Had non-accrual loans performed in accordance with their original contract terms, the Companywould have recognized additional interest income of approximately $16,000 and $53,000 in the three and nine month periods ended September 30, 2018, respectively, as compared to $27,000 and $95,000 in the same periods of 2017.

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The following table analyzes past due loans including the past due non-accrual loans in the above table, segregated by class of loans, as of September 30, 2018 (in thousands):

September 30, 2018	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	$ 17,785	$ 17,785	$ 0
Commercial R.E. - mortgages	0	0	0	0	419,690	419,690	0
Land	0	0	906	906	9,156	10,062	0
Farmland	0	0	0	0	60,866	60,866	0
Commercial and industrial	0	0	0	0	80,932	80,932	0
Consumer	0	1	0	1	1,055	1,056	0
Consumer residential	48	0	0	48	35,717	35,765	0
Agriculture	0	0	0	0	37,039	37,039	0
Total	$ 48	$ 1	$ 906	$ 955	$ 662,240	$ 663,195	$ 0

The following table analyzes past due loans including the past due non-accrual loans in the above table, segregated by class of loans, as of December 31, 2017 (in thousands):

December 31, 2017	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	$31,265	$31,265	$ 0
Commercial R.E. - mortgages	0	0	0	0	417,138	417,138	0
Land	0	0	993	993	9,079	10,072	0
Farmland	0	0	0	0	58,675	58,675	0
Commercial and industrial	19	0	302	321	69,289	69,610	0
Consumer	0	0	0	0	689	689	0
Consumer residential	0	0	0	0	37,161	37,161	0
Agriculture	0	0	0	0	37,934	37,934	0
Total	$ 19	$ 0	$1,295	$1,314	$661,230	$662,544	$ 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 nine months ended September 30, 2018 and 2017.

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Impaired loans as of September 30, 2018 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
September 30, 2018					
Commercial real estate:					
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	1,222	0	906	906	680
Farmland	0	0	0	0	0
Commercial and Industrial	32	0	0	0	0
Consumer	0	0	0	0	0
Consumer residential	15	14	0	14	0
Agriculture	0	0	0	0	0
Total	$ 1,269	$ 14	$ 906	$ 920	$ 680

Average recorded investment in impaired loans outstanding as of September 30, 2018 and 2017 is set forth in the following table.

(in thousands)	Average Recorded Investment for the Three Months Ended September 30,		Average Recorded Investment for the Nine Months Ended September 30,	
	2018	2017	2018	2017
Commercial real estate:				
Commercial R.E. - construction	$0	$0	$0	$0
Commercial R.E. - mortgages	0	0	0	0
Land	942	1,518	2,018	2,273
Farmland	0	0	0	0

Commercial and Industrial	105	302	304	305
Consumer	0	0	0	0
Consumer residential	14	75	96	107
Agriculture	0	0	0	0
Total	$1,061	$1,895	$2,418	$2,685

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Impaired loans as of December 31, 2017 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
December 31, 2017						
Commercial real estate:						
Commercial R.E. - construction	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Commercial R.E. - mortgages	0	0	0	0	0	0
Land	1,309	0	993	993	680	1,760
Farmland	0	0	0	0	0	0
Commercial and Industrial	334	302	0	302	0	303
Consumer	0	0	0	0	0	0
Consumer residential	16	16	0	16	0	76
Agriculture	0	0	0	0	0	0
Total	$ 1,659	$ 318	$ 993	$ 1,311	$ 680	$ 2,139

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, 2018, there were 4 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $920,000. At December 31, 2017, there were 4 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling $1,311,000. At September 30, 2018 and December 31, 2017 there were no unfunded commitments on loans classified as a troubled debt restructures. The Company has allocated $680,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of September 30, 2018 and December 31, 2017.

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 nine months ended September 30, 2018 and 2017, no loans were modified as troubled debt restructurings. 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, 2018 and 2017. 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.

The Company grades 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.

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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 a 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.).

-Any managerial or personal problems of company management, decline in the entire industry or local economic conditions, or failure to provide financial information or other documentation as requested.

-Issues regarding delinquency, overdrafts, or renewals.

-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 as substandard.

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7 Doubtful Loan - An extension of credit classified as “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 as 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 as 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 as “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, 2018 and December 31, 2017, there are no loans that are classified with a risk grade of *8- Loss.*

The following table presents weighted average risk grades of the Company’s loan portfolio:

	September 30, 2018	December 31, 2017
	Weighted Average	Weighted Average

	Risk Grade	Risk Grade
Commercial real estate:		
Commercial real estate - construction	3.00	3.08
Commercial real estate - mortgages	3.02	3.01
Land	3.63	3.71
Farmland	3.00	3.14
Commercial and industrial	3.09	3.09
Consumer	2.21	2.34
Consumer residential	3.01	3.01
Agriculture	3.19	3.19
Total gross loans	3.04	3.05

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The following table presents risk grade totals by class of loans as of September 30, 2018 and December 31, 2017. 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, 2018									
Pass	$ 17,785	$ 416,114	$ 9,156	$ 60,866	$ 75,054	$ 1,030	$ 35,708	$ 34,589	$ 650,302
Special mention	-	2,889	-	-	5,878	-	-	2,450	11,217
Substandard	-	687	906	-	-	26	57	-	1,676
Doubtful	-	-	-	-	-	-	-	-	-
Total loans	$ 17,785	$ 419,690	$ 10,062	$ 60,866	$ 80,932	$ 1,056	$ 35,765	$ 37,039	$ 663,195
December 31, 2017									
Pass	$ 30,008	$ 416,437	$ 8,901	$ 58,675	$ 65,313	$ 662	$ 37,100	$ 37,934	$ 655,030
Special mention	1,257	-	-	-	3,762	-	-	-	5,019
Substandard	-	701	1,171	-	535	27	61	-	2,495
Doubtful	-	-	-	-	-	-	-	-	-
Total loans	$ 31,265	$ 417,138	$ 10,072	$ 58,675	$ 69,610	$ 689	$ 37,161	$ 37,934	$ 662,544

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.

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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.

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The following table details activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2018 and 2017. 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, 2018 and 2017

(in thousands) **Three Months Ended September 30, 2018**	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Beginning balance	$ 6,022	$ 873	$ 22	$ 304	$ 698	$ 243	$ 8,162
Charge-offs	0	0	(11)	(17)	0	0	(28)
Recoveries	0	0	1	0	0	0	1
Provision for (reversal of) loan losses	83	82	19	22	(16)	(190)	0
Ending balance	$ 6,105	$ 955	$ 31	$ 309	$ 682	$ 53	$ 8,135

(in thousands) **Nine Months Ended September 30, 2018**	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Beginning balance	$ 6,331	$ 813	$ 27	$ 300	$ 693	$ 2	$ 8,166
Charge-offs	0	0	(22)	(17)	0	0	(39)
Recoveries	0	0	7	1	0	0	8
Provision for (reversal of) loan losses	(226)	142	19	25	(11)	51	0
Ending balance	$ 6,105	$ 955	$ 31	$ 309	$ 682	$ 53	$ 8,135

(in thousands) **Three Months Ended September 30, 2017**	Commercial Real Estate	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Unallocated	Total
Beginning balance	$ 6,247	$ 746	$ 30	$ 321	$ 453	$ 57	$ 7,854
Charge-offs	-	-	(9)	-	-	-	(9)
Recoveries	-	-	2	-	-	-	2
	3	15	-	(7)	100	(41)	70

Provision for (reversal of) loan losses							
Ending balance	$ 6,250	$ 761	$ 23	$ 314	$ 553	$ 16	$7,917

(in thousands)	Commercial	Commercial		Consumer			
Nine Months Ended September 30, 2017	Real Estate	and Industrial	Consumer	Residential	Agriculture	Unallocated	Total
Beginning balance	$ 6,185	$ 697	$ 51	$ 325	$ 504	$ 70	$7,832
Charge-offs	-	-	(26)	-	-	-	(26)
Recoveries	-	-	5	1	-	-	6
Provision for (reversal of) loan losses	65	64	(7)	(12)	49	(54)	105
Ending balance	$ 6,250	$ 761	$ 23	$ 314	$ 553	$ 16	$7,917

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The following table details the allowance for loan losses and ending gross loan balances as of September 30, 2018, December 31, 2017 and September 30, 2017 summarized by collective and individual evaluation methods of impairment.

(in thousands)	Commercial	Commercial		Consumer			
September 30, 2018	Real Estate	and Industrial	Consumer	Residential	Agriculture	Unallocated	Total
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 680	$ 0	$ 0	$ 0	$ 0		$ 680
Collectively evaluated for impairment	5,425	955	31	309	682	53	7,455
	$ 6,105	$ 955	$ 31	$ 309	$ 682	$ 53	$ 8,135
Ending gross loan balances:							
Individually evaluated for impairment	$ 906	$ 0	$ 0	$ 14	$ 0	$ 0	$ 920
Collectively evaluated for impairment	507,497	80,932	1,056	35,751	37,039	0	662,275
	$ 508,403	$ 80,932	$ 1,056	$ 35,765	$ 37,039	$ 0	$ 663,195
December 31, 2017							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 680	$ 0	$ 0	$ 0	$ 0		$ 680
Collectively evaluated for impairment	5,651	813	27	300	693	2	7,486
	$ 6,331	$ 813	$ 27	$ 300	$ 693	$ 2	$ 8,166
Ending gross loans balances:							
Individually evaluated for impairment	$ 993	$ 303	$ 0	$ 15	$ 0	$ 0	$ 1,311
Collectively evaluated for impairment	516,157	69,307	689	37,146	37,934	0	661,233
	$ 517,150	$ 69,610	$ 689	$ 37,161	$ 37,934	$ 0	$ 662,544
September 30, 2017							
Allowance for loan losses for loans:							
Individually evaluated for impairment	$ 680	$ 0	$ 0	$ 0	$ 0		$ 680
Collectively evaluated for impairment	5,570	761	23	314	553	16	7,237
	$ 6,250	$ 761	$ 23	$ 314	$ 553	$ 16	$ 7,917

Ending gross loan balances:							
Individually evaluated for impairment	$ 993	$ 303	$ 0	$ 15	$ 0	$ 0	$ 1,311
Collectively evaluated for impairment	501,680	65,141	607	37,821	30,049	0	635,298
	$ 502,673	$ 65,444	$ 607	$ 37,836	$ 30,049	$ 0	$ 636,609

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

	THREE MONTHS ENDED SEPTEMBER 30,		**NINE MONTHS ENDED SEPTEMBER 30,**	
	2018	**2017**	**2018**	**2017**
Balance, beginning of period	$ 372	$ 302	$ 305	$ 284
Provision (Recovery) to Operations for Off Balance Sheet Commitments	19	(4)	86	14
Balance, end of period	$ 391	$ 298	$ 391	$ 298

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 September 30, 2018 and December 31, 2017, loans carried at $663,195,000 and $662,544,000, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.

NOTE 5 – OTHER REAL ESTATE OWNED

As of September 30, 2018, the Company owned one property classified as other real estate with no carrying value, as compared to two properties totaling $253,000 as of December 31, 2017. The property owned at September 30, 2018 and December 31, 2017, was a residential land property that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. This other real estate asset ("OREO") property and the other property owned at December 31, 2017 were acquired through loan foreclosures. During the nine months ended September 30, 2018, there was one sale of an OREO property resulting in a gain on sale of $193,000, and there were no OREO property acquisitions. During the nine months ended September 30, 2017, there was one sale of an OREO property resulting in a gain on sale of $211,000, and there were no OREO property acquisitions.

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value as of 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 — GOODWILL AND OTHER INTANGIBLE ASSETS

Intangible assets are comprised of goodwill and core deposit intangibles that were acquired through a business combination. Intangible assets with definite useful lives are amortized over their respective estimated useful lives. If an event occurs that indicates the carrying amount of an intangible asset may not be recoverable, management reviews the asset for impairment. Any goodwill and any intangible asset acquired in a purchase business combination determined to have an indefinite useful life is not amortized, but is evaluated for impairment, at a minimum, on an annual basis.

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. 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, 2018. At September 31, 2018, the core deposit intangibles future estimated amortization expense is as follows:

(in thousands)	2018	2019	2020	2021	2022	Thereafter	Total
Core deposit intangible amortization	$ 29	$ 105	$ 96	$ 93	$ 89	$ 236	$ 648

The Company applies a qualitative analysis of conditions in order to determine if it is more likely than not that the carrying value is impaired. In the event that the qualitative analysis suggests that the carrying value of goodwill may be impaired, the Company, with the assistance of an independent third party valuation firm, uses several quantitative valuation methodologies in evaluating goodwill for impairment including a discounted cash flow approach that includes assumptions made concerning the future earnings potential of the organization, and a market-based approach that looks at values for organizations of comparable size, structure and business model. The current year's review of qualitative factors did not indicate that impairment has occurred, as such no quantitative analysis was performed at September 30, 2018.

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 September 30, 2018 and December 31, 2017. 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.

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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 nine month periods ended September 30, 2018 or 2017.

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 — The fair value of the loan portfolio is estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The Company's fair value model takes into account many inputs including loan discounts due to credit risk, 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. Adoption of ASU 2016-01 during the first quarter of 2018 resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis. 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 not measured at fair value at September 30, 2018 were as follows:

(in thousands)	**Carrying Amount**	**Fair Value**	**Hierarchy Valuation Level**
Financial assets:			
Cash and cash equivalents	$162,841	$162,841	1
Restricted equity securities	4,357	4,357	2
Loans, net	653,995	651,333	3
Interest receivable	3,181	3,181	2
Financial liabilities:			
Deposits	(974,424)	(973,824)	3
Interest payable	(31)	(31)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(2,363)	3

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The estimated fair values of the Company's financial instruments not measured at fair value at December 31, 2017 were as follows:

(in thousands)	Carrying Amount	Fair Value	Hierarchy Valuation Level
Financial assets:			
Cash and cash equivalents	$149,173	$149,173	1
Restricted equity securities	4,135	4,135	2
Loans, net	638,902	639,830	3
Interest receivable	3,170	3,170	2
Financial liabilities:			
Deposits	(938,882)	(829,992)	3
Interest payable	(45)	(45)	2
Off-balance-sheet assets (liabilities):			
Commitments and standby letters of credit		(1,180)	3