

Oak Valley Bancorp  
Form 10-Q  
August 12, 2016

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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 June 30, 2016**

**OR**

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

**Commission file number 001-34142**

**OAK VALLEY BANCORP**

(Exact name of registrant as specified in its charter)

**California**                      **26-2326676**  
State or other jurisdiction of   I.R.S. Employer  
incorporation or organization   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

Smaller reporting company

(Do not check if a 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: 8,088,155 shares of common stock outstanding as of August 8, 2016.



**Oak Valley Bancorp**

**June 30, 2016**

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**PART I – FINANCIAL STATEMENTS****OAK VALLEY BANCORP****CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

(dollars in thousands)	June 30, 2016	December 31, 2015
<b>ASSETS</b>		
Cash and due from banks	\$ 162,624	\$ 174,778
Federal funds sold	0	15,825
Cash and cash equivalents	162,624	190,603
Securities available for sale	150,299	131,546
Loans, net of allowance for loan loss of \$7,680 and \$7,356 at June 30, 2016 and December 31, 2015, respectively	569,668	530,394
Bank premises and equipment, net	13,922	14,277
Other real estate owned	1,231	2,066
Interest receivable and other assets	27,891	28,152
	\$ 925,635	\$ 897,038
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits	\$ 838,458	\$ 814,691
Interest payable and other liabilities	5,184	4,084
Total liabilities	843,642	818,775
Shareholders' equity		
Common stock, no par value; 50,000,000 shares authorized, 8,088,155 and 8,078,155 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively	24,682	24,682
Additional paid-in capital	3,346	3,217
Retained earnings	51,239	48,795
Accumulated other comprehensive income, net of tax	2,726	1,569

Total shareholders' equity	81,993	78,263
	\$925,635	\$897,038

*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,	
	2016	2015	2016	2015
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$7,129	\$5,376	\$13,677	\$10,779
Interest on securities available for sale	1,016	898	1,993	1,773
Interest on federal funds sold	5	9	14	17
Interest on deposits with banks	147	72	323	139
Total interest income	8,297	6,355	16,007	12,708
<b>INTEREST EXPENSE</b>				
Deposits	191	155	359	307
Total interest expense	191	155	359	307
Net interest income	8,106	6,200	15,648	12,401
Provision for (reversal of) loan losses	125	0	325	(125 )
Net interest income after provision for (reversal of) loan losses	7,981	6,200	15,323	12,526
<b>OTHER INCOME</b>				
Service charges on deposits	337	308	670	620
Earnings on cash surrender value of life insurance	95	106	203	214
Mortgage commissions	49	42	95	88
Net gain on sales and calls of securities	12	73	18	182
Other	563	627	1,107	1,079
Total non-interest income	1,056	1,156	2,093	2,183
<b>OTHER EXPENSES</b>				
Salaries and employee benefits	3,370	2,955	6,725	5,938
Occupancy expenses	813	724	1,651	1,471
Data processing fees	440	358	911	711
Regulatory assessments (FDIC & DBO)	170	131	327	245
Other operating expenses	1,394	1,025	2,760	1,926
Total non-interest expense	6,187	5,193	12,374	10,291
Net income before provision for income taxes	2,850	2,163	5,042	4,418
<b>PROVISION FOR INCOME TAXES</b>	<b>946</b>	<b>653</b>	<b>1,629</b>	<b>1,382</b>

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NET INCOME	\$1,904	\$1,510	\$3,413	\$3,036
NET INCOME PER COMMON SHARE	\$0.24	\$0.19	\$0.43	\$0.38
NET INCOME PER DILUTED COMMON SHARE	\$0.24	\$0.19	\$0.42	\$0.38

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

**OAK VALLEY BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

(in thousands)	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30, 2016	2015	JUNE 30, 2016	2015
Net income	\$1,904	\$1,510	\$3,413	\$3,036
Other comprehensive income:				
Unrealized holding gains (losses) on securities arising during the current period, net of tax effect of \$748 thousand and \$816 thousand for the three and six month periods ended June 30, 2016 and 2015, respectively, and (\$824) and (\$783) for the comparable 2015 periods	1,069	(1,178)	1,168	(1,120)
Reclassification adjustment due to net gains realized on sales and calls of securities, net of tax effect of \$5 thousand and \$7 thousand for the three and six months ended June 30, 2016, respectively, and \$30 thousand and \$75 thousand for the comparable 2015 periods	(7 )	(43 )	(11 )	(107 )
Other comprehensive income (loss)	1,062	(1,221)	1,157	(1,227)
Comprehensive income	\$2,966	\$289	\$4,570	\$1,809

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

**OAK VALLEY BANCORP****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(UNAUDITED)**YEAR ENDED DECEMBER 31, 2015 AND SIX MONTHS ENDED  
JUNE 30, 2016

(dollars in thousands)	Common Stock		Additional	Retained	Accumulated	Total
	Shares	Amount	Paid-in Capital	Earnings	Other Comprehensive Income (Loss)	Shareholders' Equity
Balances, January 1, 2015	8,074,855	\$24,682	\$ 2,910	\$45,582	\$ 1,867	\$ 75,041
Stock options exercised						0
Tax benefit on stock based compensation			46			46
Restricted stock issued	6,000					0
Restricted stock forfeited	(2,700 )					0
Cash dividends declared				(1,695 )		(1,695 )
Stock based compensation			261			261
Other comprehensive loss					(298 )	(298 )
Net income				4,908		4,908
Balances, December 31, 2015	8,078,155	\$24,682	\$ 3,217	\$48,795	\$ 1,569	\$ 78,263
Restricted stock issued	10,000					\$ 0
Cash dividends declared				(969 )		(969 )
Stock based compensation			129			129
Other comprehensive income					1,157	1,157
Net income				3,413		3,413
Balances, June 30, 2016	8,088,155	\$24,682	\$ 3,346	\$51,239	\$ 2,726	\$ 81,993

*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,	
	2016	2015
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$3,413	\$3,036
Adjustments to reconcile net earnings to net cash from operating activities:		
Provision (reversal of provision) for loan losses	325	(125 )
Decrease in deferred fees/costs, net	(132 )	(46 )
Depreciation	646	588
Amortization of investment securities, net	164	87
Stock based compensation	129	123
Gain on sale of premises and equipment	(1 )	(5 )
OREO write downs and losses on sale	88	50
Gain on sales and calls of available for sale securities	(18 )	(182 )
Earnings on cash surrender value of life insurance	(203 )	(214 )
Gain on BOLI death benefit	(2 )	(66 )
Increase (decrease) in interest payable and other liabilities	1,100	(1,137 )
Increase in interest receivable	(125 )	(111 )
Increase in other assets	(324 )	(260 )
Net cash from operating activities	5,060	1,738
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of available for sale securities	(32,286 )	(25,084 )
Proceeds from maturities, calls, and principal paydowns of securities available for sale	15,353	16,475
Net increase in loans	(39,467 )	(9,011 )
Purchase of FHLB Stock	(79 )	0
Proceeds from sale of OREO	746	0
Proceeds from redemption of BOLI policies	186	292
Proceeds from sales of premises and equipment	1	5
Net purchases of premises and equipment	(291 )	(237 )
Net cash used in investing activities	(55,837 )	(17,560 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Shareholder cash dividends paid	(969 )	(808 )
Net increase in demand deposits and savings accounts	22,180	15,841
Net increase (decrease) in time deposits	1,587	(1,485 )
Net cash from financing activities	22,798	13,548
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(27,979 )</b>	<b>(2,274 )</b>
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	<b>190,603</b>	<b>144,288</b>

CASH AND CASH EQUIVALENTS, end of period	\$162,624	\$142,014
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SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest	\$368	\$318
Income taxes	\$11	\$1,940

NON-CASH INVESTING ACTIVITIES:

Change in unrealized gain (loss) on available-for-sale securities	\$1,966	\$(9 )
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*The accompanying notes are an integral part of these consolidated financial statements.*

**OAK VALLEY BANCORP**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 – BASIS OF PRESENTATION**

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

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

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

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

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

estimates.

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

## **NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS**

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

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

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



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

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

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

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

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

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

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

### **NOTE 3 – ACQUISITION**

On December 23, 2015, in effort to expand our market presence and enhance shareholder value, the Company acquired 100% of the outstanding common shares of Mother Lode Bank ("MLB") and all unexercised options to purchase MLB common stock were cancelled, in exchange for \$7,336,000 in cash (the "MLB Acquisition"). In

conjunction with the MLB Acquisition, MLB was merged with and into Oak Valley Community Bank. On January 29, 2016, the two acquired MLB branches in Sonora were closed after management determined that our two existing branches in Sonora would be able to support our new customers. The assets acquired and liabilities assumed, both tangible and intangible, were recorded at their fair values as of the acquisition date in accordance with ASC 805. We have not identified additional information that existed at the acquisition date that would affect the measurement of assets acquired and liabilities assumed. Accordingly, there have been no changes in the fair value of assets acquired or liabilities assumed since the acquisition date. The acquisition was treated as a "reorganization" within the definition of section 368(a) of the Internal Revenue Code and is generally considered tax-free for U.S. federal income tax purposes.

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

(Dollars in thousands)	Acquisition Date December 23, 2015
<b>Assets:</b>	
Cash and cash equivalents	\$ 30,804
Loans	42,831
Core deposit intangible	1,031
Deferred tax asset	2,651
Goodwill	662
Other assets	738
Total assets acquired	\$ 78,717
<b>Liabilities:</b>	
Deposits:	
Non-interest bearing	\$ 36,177
Interest bearing	
Transaction accounts	6,112
Savings accounts	15,727
Money market accounts	7,602
Other time accounts	5,507
Total deposits	71,125
Other liabilities	256
Total liabilities assumed	\$ 71,381
Merger consideration	\$ 7,336

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

(Dollars in thousands)	Acquisition Date December 23, 2015
Book value of net assets acquired from Mother Lode Bank	\$ 4,884
Fair value adjustments:	
Loans	(2,960 )
Reversal of Allowance for Loan Loss	1,279
Core deposit intangible asset	1,031
Other assets & liabilities, net	(210 )
Total purchase accounting adjustments	\$ (860 )
Deferred tax asset (tax effect of purchase accounting adjustments at 41.15%)	354
DTA Carryforward	2,296
Fair value of net assets acquired from Mother Lode Bank	\$ 6,674
Merger consideration	7,336
Less: fair value of net assets acquired	(6,674 )
Goodwill	\$ 662

As a result of the MLB Acquisition, we recorded \$662,000 in goodwill, which represents the excess of the total purchase price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed. Goodwill mainly reflects expected value created through the combined operations of MLB and the Company. At December 31, 2015, we determined that the fair value of our traditional community banking activities (provided through our branch network) exceeded the carrying amount. Therefore, no impairment on goodwill has been recorded. The following is a description of the methods used to determine the fair values of significant assets and liabilities at acquisition date presented above.

### Loans

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

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

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

#### Core Deposit Intangible

The core deposit intangible represents the estimated future benefits of acquired deposits and is booked separately from the related deposits. The value of the core deposit intangible asset was determined using a discounted cash flow approach to arrive at the cost differential between the core deposits (non-maturity deposits such as transaction, savings and money market accounts) and alternative funding sources. A core deposit intangible asset of \$1,031,000 was recorded on December 23, 2015, of which \$40,000 and \$81,000 was amortized during the three and six month periods ended June 30, 2016, respectively. The core deposit intangible is amortized on an accelerated basis over an estimated ten-year life, and it is evaluated periodically for impairment. No impairment loss was recognized as of June 30, 2016.

Acquisition Related Expenses

Acquisition-related expenses are recognized as incurred and continue until all systems have been converted and operational functions become fully integrated. We incurred one-time third-party acquisition-related expenses in the consolidated statements of income totaling \$83,000 and \$141,000 during the three and six month periods ended June 30, 2016, respectively. The conversion of the operating systems was completed in April 2016.

**NOTE 4 – SECURITIES**

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

(dollars in thousands)	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
Available-for-sale securities:				
U.S. agencies	\$ 29,075	\$ 1,171	\$ (4	) \$30,242
Collateralized mortgage obligations	4,505	25	(10	) 4,520
Municipalities	72,458	4,116	(14	) 76,560
SBA pools	788	0	(4	) 784
Corporate debt	19,345	25	(298	) 19,072
Asset backed securities	16,277	15	(265	) 16,027
Mutual fund	3,218	0	(124	) 3,094
	<b>\$ 145,666</b>	<b>\$ 5,352</b>	<b>\$ (719</b>	<b>) \$ 150,299</b>

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, 2016.

(dollars in thousands)	<b>Less than 12 months</b>		<b>12 months or more</b>		<b>Total</b>	
<b><u>Description of Securities</u></b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>

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	<b>Value</b>	<b>Loss</b>		<b>Value</b>	<b>Loss</b>		<b>Value</b>	<b>Loss</b>
U.S. agencies	\$3,795	\$ (4	)	\$0	\$ 0	)	\$3,795	\$ (4 )
Collateralized mortgage obligations	2,111	(10	)	0	0	)	2,111	(10 )
Municipalities	1,472	(10	)	428	(4	)	1,900	(14 )
SBA pools	0	0	)	783	(4	)	783	(4 )
Corporate debt	13,569	(284	)	478	(14	)	14,047	(298 )
Asset backed securities	2,864	(44	)	9,659	(221	)	12,523	(265 )
Mutual fund	0	0	)	3,094	(124	)	3,094	(124 )
Total temporarily impaired securities	\$23,811	\$ (352	)	\$14,442	\$ (367	)	\$38,253	\$ (719 )

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

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

(dollars in thousands)

	<b>Amortized Cost</b>	<b>Fair Value</b>
Available-for-sale securities:		
Due in one year or less	\$ 8,550	\$9,038
Due after one year through five years	48,517	49,908
Due after five years through ten years	56,321	57,947
Due after ten years	32,278	33,406
	\$ 145,666	\$ 150,299

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

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

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



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(dollars in thousands)

<u>Description of Securities</u>	<b>Less than 12 months</b>		<b>12 months or more</b>		<b>Total</b>	
	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>
	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>	<b>Value</b>	<b>Loss</b>
U.S. agencies	\$7,129	\$ (30 )	\$1,800	\$ (59 )	\$8,929	\$ (89 )
Collateralized mortgage obligations	0	0	1,266	(27 )	1,266	(27 )
Municipalities	11,451	(123 )	3,680	(74 )	15,131	(197 )
SBA pools	0	0	807	(5 )	807	(5 )
Corporate debt	9,376	(121 )	0	0	9,376	(121 )
Asset backed securities	5,351	(78 )	4,787	(105 )	10,138	(183 )
Mutual fund	0	0	3,009	(163 )	3,009	(163 )
Total temporarily impaired securities	\$33,307	\$ (352 )	\$15,349	\$ (433 )	\$48,656	\$ (785 )

We recognized gross gains of \$12,000 and \$18,000 for the three and six month periods ended June 30, 2016, respectively, on certain available-for-sale securities that were called or sold, which compares to \$73,000 in the same periods of 2015. There were no securities sold during the first six months of 2016, compared to two available-for-sale securities sold during the first six months of 2015, which resulted in a loss of \$32,000 on one sale and a gain of 13,000 on the other sale.

Securities carried at \$83,348,000 and \$65,902,000 at June 30, 2016 and December 31, 2015, respectively, were pledged to secure deposits of public funds.

**NOTE 5 – LOANS**

Our customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of June 30, 2016, approximately 78% 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, 6% of the Company's loans are for residential real estate and other consumer loans. The remaining 4% are agriculture loans. Loan totals were as follows:

(in thousands)

	June 30, 2016	December 31, 2015
Commercial real estate:		
Commercial real estate- construction	\$ 16,459	\$ 19,363
Commercial real estate- mortgages	371,393	363,644
Land	9,478	10,239
Farmland	56,260	29,801
Commercial and industrial	65,359	63,776
Consumer	910	774
Consumer residential	35,275	32,588
Agriculture	24,640	20,847
Total loans	579,774	541,032
Less:		
Deferred loan fees and costs, net	(2,426 )	(3,282 )
Allowance for loan losses	(7,680 )	(7,356 )
Net loans	\$569,668	\$530,394

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

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and solid business acumen, our management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company's commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Company's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At June 30, 2016 and December 31, 2015, commercial real estate loans equal to approximately 42.8% and 44.3%, respectively, of the outstanding principal balance of our commercial real estate loans were secured by owner-occupied properties.

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

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

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

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

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

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

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

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

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

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

(in thousands)	June 30, 2016		December 31, 2015	
	Unpaid principal balance	Carrying value	Unpaid principal balance	Carrying value
Commercial real estate:				
Commercial real estate- construction	\$0	\$ 0	\$0	\$ 0
Commercial real estate- mortgages	0	0	196	118
Land	795	286	795	269
Farmland	0	0	0	0
Commercial and industrial	529	529	794	478
Consumer	0	0	0	0
Consumer residential	0	0	0	0
Agriculture	0	0	0	0
Total purchased credit-impaired loans	\$1,324	\$ 815	\$1,785	\$ 865

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

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

is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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

(in thousands)	June 30, 2016	December 31, 2015
Commercial real estate:		
Land	\$2,340	\$ 2,739
Farmland	0	51
Commercial and industrial	314	322
Agriculture	0	2,704
Total non-accrual loans	\$2,654	\$ 5,816

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

Had non-accrual loans performed in accordance with their original contract terms, we would have recognized additional interest income of approximately \$38,000 and \$79,000 in the three and six month periods ended June 30, 2016, respectively, as compared to \$71,000 and \$153,000 in the same periods of 2015.

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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, 2016 (in thousands):

<b><u>June 30, 2016</u></b>	30-59	60-89	Greater Than 90	Total	Current	Purchased	Total	Greater Than 90
	Days Past Due	Days Past Due	Days Past Due	Past Due		Credit Impaired Loans		Days Past Due and Still Accruing
Commercial real estate:								
Commercial R.E. - construction	\$ 0	\$ 0	\$ 0	\$ 0	\$ 16,459	\$ 0	16,459	\$ 0
Commercial R.E. - mortgages	0	0	0	0	371,393	0	371,393	0
Land	0	0	2,047	2,047	7,145	286	9,478	0
Farmland	0	0	0	0	56,260	0	56,260	0
Commercial and industrial	994	0	307	1,301	63,529	529	65,359	0
Consumer	0	0	0	0	910	0	910	0
Consumer residential	0	0	0	0	35,275	0	35,275	0
Agriculture	0	0	0	0	24,640	0	24,640	0
Total	\$ 994	\$ 0	\$ 2,354	\$ 3,348	\$ 575,611	\$ 815	579,774	\$ 0

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

<b><u>December 31, 2015</u></b>	30-59	60-89	Greater Than 90	Total	Current	Purchased	Total	Greater Than 90
	Days Past Due	Days Past Due	Days Past Due	Past Due		Credit Impaired Loans		Days Past Due and Still Accruing
Commercial real estate:								
Commercial R.E. - construction	\$ 0	\$ 0	\$ 0	\$ 0	\$ 19,363	\$ 0	\$ 19,363	\$ 0



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Commercial R.E. – mortgages	0	0	0	0	363,526	118	363,644	0
Land	0	0	2,261	2,261	7,709	269	10,239	0
Farmland	1,182	0	51	1,233	28,568	0	29,801	0
Commercial and industrial	352	0	312	664	62,634	478	63,776	0
Consumer	0	0	0	0	774	0	774	0
Consumer residential	0	0	0	0	32,588	0	32,588	0
Agriculture	0	2,704	0	2,704	18,143	0	20,847	0
Total	\$1,534	\$2,704	\$2,624	\$6,862	\$533,305	\$ 865	\$541,032	\$ 0

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

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

(in thousands)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
<b><u>June 30, 2016</u></b>					
Commercial real estate:					
Commercial R.E. - construction	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	2,712	292	2,048	2,340	0
Farmland	0	0	0	0	0
Commercial and Industrial	355	314	0	314	680
Consumer	0	0	0	0	0
Consumer residential	0	0	0	0	0
Agriculture	0	0	0	0	0
Total	\$ 3,067	\$ 606	\$ 2,048	\$ 2,654	\$ 680
<b><u>December 31, 2015</u></b>					
Commercial real estate:					
Commercial R.E. - construction	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Commercial R.E. - mortgages	0	0	0	0	0
Land	3,856	0	2,739	2,739	722
Farmland	63	51	0	51	0
Commercial and Industrial	357	322	0	322	0
Consumer	0	0	0	0	0
Consumer residential	0	0	0	0	0
Agriculture	2,704	2,704	0	2,704	0
Total	\$ 6,980	\$ 3,077	\$ 2,739	\$ 5,816	\$ 722

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

(in thousands)	Average Recorded Investment for the			
	Three Months Ended June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Commercial real estate:				
Commercial R.E. - construction	\$0	\$0	\$0	\$0
Commercial R.E. - mortgages	0	0	0	324
Land	2,498	2,964	2,396	2,976
Farmland	0	64	0	67
Commercial and Industrial	318	1,360	316	1,105
Consumer	0	0	0	0
Consumer residential	0	0	0	0
Agriculture	0	0	0	0
Total	\$2,816	\$4,388	\$2,712	\$4,472

*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, 2016, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling \$2,654,000. At December 31, 2015, there were 5 loans that were considered to be troubled debt restructurings, all of which are considered non-accrual totaling \$3,060,000. At June 30, 2016 and December 31, 2015 there were no unfunded commitments on loans classified as a troubled debt restructures. We have allocated \$680,000 and \$722,000 of specific reserves to loans whose terms have been modified in troubled debt restructurings as of June 30, 2016 and December 31, 2015, respectively.

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

(dollars in thousands)	Three Months Ended		Three Months Ended	
	June 30, 2016		June 30, 2015	
	Pre-	Post-	Pre-	Post-
	Modification	Modification	Modification	Modification
	of Outstanding	Outstanding	of Outstanding	Outstanding
	Loans Recorded	Recorded	Loans Recorded	Recorded
	Investment	Investment	Investment	Investment
Commercial real estate:				
Commercial R.E. - construction	0	\$ 0	\$ 0	0
Commercial R.E. - mortgages	0	0	0	0
Land	0	0	0	1 570
Farmland	0	0	0	0 0
Commercial and industrial	0	0	0	1 24

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Consumer	0	0	0	0	0	0
Consumer residential	0	0	0	0	0	0
Agriculture	0	0	0	0	0	0
Total	0	\$ 0	\$ 0	2	\$ 594	\$ 594

(dollars in thousands)

	Six Months Ended		Six Months Ended	
	June 30, 2016		June 30, 2015	
	Pre-	Post-	Pre-	Post-
	Modification	Modification	Modification	Modification
	of Outstanding	of Outstanding	of Outstanding	of Outstanding
	Loans Recorded	Loans Recorded	Loans Recorded	Loans Recorded
	Investment	Investment	Investment	Investment
Commercial real estate:				
Commercial R.E. - construction	0	\$ 0	0	\$ 0
Commercial R.E. - mortgages	0	0	0	0
Land	1	473	1	570
Farmland	0	0	0	0
Commercial and industrial	0	0	1	24
Consumer	0	0	0	0
Consumer residential	0	0	0	0
Agriculture	0	0	0	0
Total	1	\$ 473	2	\$ 594

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

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

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

We grade loans using the following letter system:

- 1 Exceptional Loan
- 2 Quality Loan
- 3A Better Than Acceptable Loan
- 3B Acceptable Loan
- 3C Marginally Acceptable Loan
- 4(W) Watch Acceptable Loan
- 5 Other Loans Especially Mentioned
- 6 Substandard Loan
- 7 Doubtful Loan
- 8 Loss

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

- A high level of liquidity and whose debt-servicing capacity exceeds expected obligations by a substantial margin. Where leverage is below average for the industry and earnings are consistent or growing without severe vulnerability to economic cycles.
- Also included in this rating (but not mandatory unless one or more of the preceding characteristics are missing) are loans that are fully secured and properly margined by our own time instruments or U.S. blue chip securities. To be properly margined cash collateral must be equal to, or greater than, 110% of the loan amount.

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

- Unquestionable debt-servicing capacity to cover all obligations in the ordinary course of business from well-defined primary and secondary sources.
- Consistent strong earnings.
- A solid equity base.

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

- Strong earnings with no loss in last three years and ample cash flow to service all debt well above policy guidelines.
- Long term experienced management with depth and defined management succession.
- The loan has no exceptions to policy.
- Loan-to-value on real estate secured transactions is 10% to 20% less than policy guidelines.
- Very liquid balance sheet that may have cash available to pay off our loan completely.
- Little to no debt on balance sheet.

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

- Are those where the borrower has average financial strengths, a history of profitable operations and experienced management.
- Are those where the borrower can be expected to handle normal credit needs in a satisfactory manner.

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

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

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

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

- The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement.
- Questions exist regarding the condition of and/or control over collateral.
- Economic or market conditions may unfavorably affect the obligor in the future.
- A declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized.

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

7 Doubtful Loan - An extension of credit classified "doubtful" has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may



be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral or refinancing plans. The entire loan need not be classified doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the Bank. In this situation, estimates are based on liquidation value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent.

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

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

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

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

	June 30, 2016 Weighted Average	December 31, 2015 Weighted Average
	Risk Grade	Risk Grade
Commercial real estate:		
Commercial real estate - construction	3.17	3.72
Commercial real estate - mortgages	3.10	3.16
Land	2.35	4.58
Farmland	3.09	3.12
Commercial and industrial	3.16	3.57
Consumer	1.62	1.99
Consumer residential	2.97	3.01
Agriculture	3.00	3.39
Total gross loans	3.08	3.25

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

(in thousands)	Commercial R.E. Construction	Commercial R.E. Mortgages	Land	Farmland	Commercial and Industrial	Consumer	Consumer Residential	Agriculture	Total
<u>June 30, 2016</u>									
Pass	\$ 16,459	\$ 369,914	\$ 6,144	\$ 56,260	\$ 63,255	\$ 882	\$ 34,857	\$ 24,640	\$ 572,411
Special mention	-	994	-	-	300	-	37	-	1,331
Substandard	-	484	3,055	-	1,804	29	380	-	5,752
Doubtful	-	-	280	-	-	-	-	-	280
Total loans	\$ 16,459	\$ 371,392	\$ 9,479	\$ 56,260	\$ 65,359	\$ 911	\$ 35,274	\$ 24,640	\$ 579,774
<u>December 31, 2015</u>									
Pass	\$ 18,312	\$ 357,339	\$ 6,358	\$ 28,568	\$ 55,957	\$ 745	\$ 32,532	\$ 18,143	\$ 517,954

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

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

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

The Company's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; 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, 2016 and 2015. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

### Allowance for Loan Losses

#### For the Three and Six Months Ended June 30, 2016 and 2015

(in thousands)

	Commercial Real Estate	Commercial and Industrial	Consumer Consumer Residential	Consumer Residential	Agriculture	Unallocated	Total
<b><u>Three Months Ended June 30, 2016</u></b>							
Beginning balance	\$ 5,998	\$ 720	\$ 44	\$ 398	\$ 302	\$ 95	\$7,557
Charge-offs	0	0	(4 )	0	0	0	(4 )
Recoveries	0	0	2	0	0	0	2
Provision for (reversal of) loan losses	135	(49 )	13	(11 )	129	(92 )	125
Ending balance	\$ 6,133	\$ 671	\$ 55	\$ 387	\$ 431	\$ 3	\$7,680
<b><u>Six Months Ended June 30, 2016</u></b>							
Beginning balance	\$ 5,920	\$ 627	\$ 38	\$ 426	\$ 309	\$ 36	\$7,356
Charge-offs	-	-	(7 )	-	-	-	(7 )
Recoveries	3	-	3	-	-	-	6
(Reversal of) provision for loan losses	210	44	21	(39 )	122	(33 )	325
Ending balance	\$ 6,133	\$ 671	\$ 55	\$ 387	\$ 431	\$ 3	\$7,680

(in thousands)

	Commercial Real Estate	Commercial and Industrial	Consumer Consumer Residential	Consumer Residential	Agriculture	Unallocated	Total
<b><u>Three Months Ended June 30, 2015</u></b>							
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	73	(102 )	15	(75 )	82	7	0

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(reversal of  
provision)  
loan losses

Ending balance	\$ 5,884	\$ 583	\$ 45	\$ 480	\$ 263	\$ 135	\$7,390
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**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

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

(in thousands)

	Commercial Real Estate	Commercial and Industrial	Commercial Consumer	Consumer Residential	Agriculture	Unallocated	Total
<b><u>June 30, 2016</u></b>							
Allowance for loan losses for loans:							
Individually evaluated for impairment	\$ 680	\$ 0	\$ 0	\$ 0	\$ 0		\$ 680
Collectively evaluated for impairment	5,453	671	55	387	431	3	7,000
	\$ 6,133	\$ 671	\$ 55	\$ 387	\$ 431	\$ 3	\$ 7,680
Ending gross loan balances:							
Individually evaluated for impairment	\$ 2,340	\$ 314	\$ 0	\$ 0	\$ 0	\$ 0	\$ 2,654
Individually evaluated purchased credit impaired loans	286	529	0	0	0	0	815
Collectively evaluated for impairment	450,964	64,516	910	35,275	24,640	0	576,305
	\$ 453,590	\$ 65,359	\$ 910	\$ 35,275	\$ 24,640	\$ 0	\$ 579,774
<b><u>December 31, 2015</u></b>							
Allowance for loan losses for loans:							
Individually evaluated for impairment	\$ 722	\$ 0	\$ 0	\$ 0	\$ 0		\$ 722
Collectively evaluated for impairment	5,198	627	38	426	309	36	6,634
	\$ 5,920	\$ 627	\$ 38	\$ 426	\$ 309	\$ 36	\$ 7,356
Ending balances of loans:							
Individually evaluated for impairment	\$ 2,790	\$ 322	\$ 0	\$ 0	\$ 2,704	\$ 0	\$ 5,816
Individually evaluated purchased credit impaired loans	387	478	0	0	0	0	865
Collectively evaluated for impairment	419,870	62,976	774	32,588	18,143	0	534,351



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\$ 423,047    \$ 63,776    \$ 774    \$ 32,588    \$ 20,847    \$ 0    \$ 541,032

**June 30, 2015**

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

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

	<b>THREE MONTHS ENDED JUNE 30, 2016</b>		<b>SIX MONTHS ENDED JUNE 30, 2015</b>	
Balance, beginning of period	\$264	\$227	\$238	\$218
(Recovery) Provision to Operations for Off Balance Sheet Commitments	(7)	7	19	16
Balance, end of period	\$257	\$234	\$257	\$234

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, 2016 and December 31, 2015, loans carried at \$579,774,000 and \$541,032,000, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.



## **NOTE 6 – OTHER REAL ESTATE OWNED**

As of June 30, 2016, the Company owned three properties classified as other real estate totaling \$1,231,000, compared to five properties totaling \$2,066,000 as of December 31, 2015. Each of the OREO properties was acquired through loan foreclosure, except for one property with a balance of \$275,000 that was acquired in the Mother Lode Bank acquisition. One of the properties owned at June 30, 2016 and December 31, 2015, 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. There was one sale during the six months ended June 30, 2016 that accounted for the disposition of two OREO properties, and there were no sales during the six months ended June 30, 2015.

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 7– 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 ten to 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.

In August 2001, the Board of Directors of the Bank authorized Director Retirement Plans (“DRP”) with each director. The Bank awarded a director retirement plan 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 10 years. The salary continuation liability as of June 30, 2016 and December 31, 2015 was \$2,463,000 and \$2,440,000, 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 \$13,766,000 and \$13,747,000 at June 30, 2016 and December 31, 2015, respectively.

## **NOTE 8 — 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, 2016 and December 31, 2015. 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.

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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 six month periods ended June 30, 2016 or 2015.

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 not measured at fair value at June 30, 2016 were as follows:

(in thousands)	<b>Carrying</b>	<b>Fair</b>	<b>Hierarchy</b>
	<b>Amount</b>	<b>Value</b>	<b>Valuation</b>
			<b>Level</b>
<b>Financial assets:</b>			
Cash and cash equivalents	\$ 162,624	162,624	1
Restricted equity securities	3,795	3,795	2
Loans, net	569,668	576,177	3
Interest receivable	2,545	2,545	2
<b>Financial liabilities:</b>			
Deposits	(838,458)	(775,136)	3
Interest payable	(28 )	(28 )	2
<b>Off-balance-sheet assets (liabilities):</b>			
Commitments and standby letters of credit		(1,030 )	3

The estimated fair values of the Company's financial instruments not measured at fair value at December 31, 2015 were as follows:

(in thousands)	<b>Carrying</b>	<b>Fair</b>	<b>Hierarchy</b>
	<b>Amount</b>	<b>Value</b>	<b>Valuation</b>
			<b>Level</b>
<b>Financial assets:</b>			
Cash and cash equivalents	\$ 190,603	\$ 190,603	1
Restricted equity securities	3,716	3,716	2
Loans, net	530,394	537,761	3
Interest receivable	2,420	2,420	2
<b>Financial liabilities:</b>			
Deposits	(814,691)	(725,982)	3
Interest payable	(36 )	(36 )	2
<b>Off-balance-sheet assets (liabilities):</b>			
Commitments and standby letters of credit		(917 )	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, 2016 and December 31, 2015.

**Fair Value Measurements at June 30, 2016  
Using**

(in thousands)	<b>June 30, 2016</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Assets and liabilities measured on a recurring basis:				
Available-for-sale securities:				
U.S. agencies	\$30,242	\$ 0	\$ 30,242	\$ 0
Collateralized mortgage obligations	4,520	0	4,520	0
Municipalities	76,560	0	76,560	0
SBA pools	784	0	784	0
Corporate debt	19,072	0	19,072	0
Asset backed securities	16,027	0	16,027	0
Mutual fund	3,094	3,094	0	0
Assets and liabilities measured on a non-recurring basis:				
Impaired loans:				
Land	\$2,047	\$ 0	\$ 0	\$ 2,047
Commercial and industrial	307	0	0	307
Other real estate owned	1,231	0	0	1,231

**Fair Value Measurements at December 31,  
2015 Using**

(in thousands)	<b>December 31, 2015</b>	<b>Quoted Prices in Active</b>	<b>Significant Other Observable Inputs</b>	<b>Significant Unobservable Inputs (Level 3)</b>
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**Markets (Level 2)  
for  
Identical  
Assets  
(Level 1)**

Assets and liabilities measured on a recurring basis:

Available-for-sale securities

U.S. agencies	\$32,868	\$ 0	\$ 32,868	\$ 0
Collateralized mortgage obligations	2,719	0	2,719	0
Municipalities	68,586	0	68,586	0
SBA pools	806	0	806	0
Corporate debt	13,420	0	10,944	2,476
Asset backed securities	10,138	0	10,138	0
Mutual fund	3,009	3,009	0	0

Assets and liabilities measured on a non-recurring basis:

Impaired loans:

Land	\$1,965	\$ 0	\$ 0	\$ 1,965
Other real estate owned	\$2,066	\$ 0	\$ 0	\$ 2,066

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Available-for-sale securities - Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, if available. If quoted market prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions, and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets where significant inputs are unobservable.

Impaired loans - ASC Topic 820 applies to loans measured for impairment using the practical expedients permitted by ASC Topic 310, *Accounting by Creditors for Impairment of a Loan*. The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Impaired loans where an allowance is established based on the fair value of collateral less the cost related to liquidation of the collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as non-recurring Level 3. Likewise, when an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as non-recurring Level 3.

Other Real Estate Owned - Other real estate assets ("OREO") acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses, subsequent to foreclosure. Appraisals or evaluations are then done periodically thereafter charging any additional write-downs or valuation allowances to the appropriate expense accounts. Values are derived from appraisals of underlying collateral and discounted cash flow analysis. OREO is classified within Level 3 of the hierarchy.

Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When the appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market

conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by management on a case-by-case basis. No fair value adjustments were made to OREO properties during the three and six months ended June 30, 2016.

There have been no significant changes in the valuation techniques during the period ended June 30, 2016.

**NOTE 9 – EARNINGS PER SHARE**

Earnings per share (“EPS”) are based upon the weighted average number of common shares outstanding during each year. The following table shows: (1) weighted average basic shares, (2) effect of dilutive securities related to stock options and non-vested restricted stock, and (3) weighted average shares of common stock and common stock equivalents. Net income available to common stockholders is calculated as net income reduced by dividends accumulated on preferred stock, if any. Basic EPS are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average diluted shares, which reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The dilutive shares included in year-to-date diluted EPS is a weighted average of the dilutive shares included in each quarterly diluted EPS computation under the treasury stock method. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of restricted stock awards receive non-forfeitable dividends at the same rate as common stockholders and they both share equally in undistributed earnings. Therefore, under the two class method the difference in EPS is not significant for these participating securities.

The Company’s calculation of basic and diluted earnings per share (“EPS”) for the three and six month periods ended June 30, 2016 and 2015 are reflected in the table below.

(In thousands)	<b>THREE MONTHS ENDED</b>	
	<b>JUNE 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>BASIC EARNINGS PER SHARE</b>		
Net income	\$1,904	\$1,510
Weighted average shares outstanding	8,028	7,992
Net income per common share	\$0.24	\$0.19
<b>DILUTED EARNINGS PER SHARE</b>		
Net income	\$1,904	\$1,510
Weighted average shares outstanding	8,028	7,992
Effect of dilutive stock options	1	1
Effect of dilutive non-vested restricted shares	31	43
Weighted average shares of common stock and common stock equivalents	8,060	8,037
Net income per diluted common share	\$0.24	\$0.19

(In thousands)	<b>SIX MONTHS ENDED</b>	
	<b>JUNE 30, 2016</b>	<b>2015</b>
<b>BASIC EARNINGS PER SHARE</b>		
Net income	\$3,413	\$3,036
Weighted average shares outstanding	8,018	7,982
Net income per common share	\$0.43	\$0.38
<b>DILUTED EARNINGS PER SHARE</b>		
Net income	\$3,413	\$3,036
Weighted average shares outstanding	8,018	7,982
Effect of dilutive stock options	1	2
Effect of dilutive non-vested restricted shares	37	47
Weighted average shares of common stock and common stock equivalents	8,056	8,031
Net income per diluted common share	\$0.42	\$0.38

During the three and six month periods ended June 30, 2016, anti-dilutive weighted average options to purchase 26,500 and 27,505 shares of common stock were outstanding, respectively, with prices ranging from \$9.95 to \$15.00. Anti-dilutive weighted average stock options of 51,843 and 56,919 were outstanding during the three and six month periods of 2015, respectively, with prices ranging from \$9.95 to \$15.67. These options were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares. These options begin to expire in 2016.

There were no anti-dilutive non-vested restricted stock grants for the three and six months ended June 30, 2016 and 2015.

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

The following discussion explains the significant factors affecting our operations and financial position for the periods presented. The discussion should be read in conjunction with our financial statements and the notes related thereto which appear or that are referenced to elsewhere in this report, and with the audited consolidated financial statements and accompanying notes included in our 2015 Annual Report on Form 10-K, as amended. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions. This discussion and analysis includes executive management's ("Management") insight of the Company's financial condition and results of operations of Oak Valley Bancorp and its subsidiary. Unless otherwise stated, the "Company" refers to the consolidated entity, Oak Valley Bancorp, while the "Bank" refers to Oak Valley Community Bank.

### ***Forward-Looking Statements***

*Some matters discussed in this Form 10-Q may be "forward-looking statements" within the meaning of the Private Litigation Reform Act of 1995 and therefore may involve risks, uncertainties and other factors which may cause our actual results to be materially different from the results expressed or implied by our forward-looking statements. These statements generally appear with words such as "anticipate," "believe," "estimate," "may," "intend," and "expect." Although management believes that the assumptions and expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to: economic conditions (both generally and in the markets where the Company operates); competition from other providers of financial services offered by the Company; changes in government regulation and legislation; changes in interest rates; material unforeseen changes in the financial stability and liquidity of the Company's credit customers; risks associated with concentrations in real estate related loans; changes in accounting standards and interpretations; and other risks as may be detailed from time to time in the Company's filings with the Securities and Exchange Commission, all of which are difficult to predict and which may be beyond the control of the Company or the Company. The Company undertakes no obligation to revise forward-looking statements to reflect events or changes after the date of this discussion or to reflect the occurrence of unanticipated events.*



*Forward-looking statements speak only as of the date they are made, and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made, whether as a result of new information, future developments or otherwise, except as may be required by law.*

## **Critical Accounting Estimates**

*Management has determined the following five accounting policies to be critical:*

### *Allowance for Loan Losses*

Accounting for allowance for loan losses involves significant judgment and assumptions by management and is based on historical data and management's view of the current economic environment. At least on a quarterly basis, our management reviews the methodology and adequacy of allowance for loan losses and reports its assessment to the Board of Directors for its review and approval.

We base our allowance for loan losses on an estimation of probable losses inherent in our loan portfolio. Our methodology for assessing loan loss allowances are intended to reduce the differences between estimated and actual losses and involves a detailed analysis of our loan portfolio in three phases:

the specific review of individual loans,

the segmenting and review of loan pools with similar characteristics, and

our judgmental estimate based on various subjective factors.

The first phase of our methodology involves the specific review of individual loans to identify and measure impairment. We evaluate each loan by use of a risk rating system, except for homogeneous loans, such as automobile loans and home mortgages. Specific risk rated loans are deemed impaired if all amounts, including principal and interest, will likely not be collected in accordance with the contractual terms of the related loan agreement.

Impairment for commercial and real estate loans is measured either based on the present value of the loan's expected future cash flows or, if collection on the loan is collateral dependent, the estimated fair value of the collateral, less selling and holding costs.

The second phase involves the segmenting of the remainder of the risk rated loan portfolio into groups or pools of loans, together with loans with similar characteristics, for evaluation. We determine the calculated loss ratio to each loan pool based on its historical net losses and benchmark it against the levels of other peer banks.

In the third phase, we consider relevant internal and external factors that may affect the collectability of loan portfolio and each group of loan pool. The factors considered are, but are not limited to:

concentration of credits,

nature and volume of the loan portfolio,

delinquency trends,

non-accrual loan trend,

problem loan trend,

loss and recovery trend,

quality of loan review,

lending and management staff,

lending policies and procedures,

economic and business conditions, and

other external factors, including regulatory review.

Our management estimates the probable effect of such conditions based on our judgment, experience and known or anticipated trends. Such estimation may be reflected as an additional allowance to each group of loans, if necessary. Management reviews these conditions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's

estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specific, identifiable problem credit or portfolio segment as of the evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the unallocated allowance.

Central to our credit risk management and our assessment of appropriate loss allowance is our loan risk rating system. Under this system, the originating credit officer assigns borrowers an initial risk rating based on a thorough analysis of each borrower's financial capacity in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior line and credit administration personnel. Credits are monitored by line and credit administration personnel for deterioration in a borrower's financial condition which may impact the ability of the borrower to perform under the contract. Although management has allocated a portion of the allowance to specific loans, specific loan pools, and off-balance sheet credit exposures (which are reported separately as part of other liabilities), the adequacy of the allowance is considered in its entirety.

#### *Non-Accrual Loan Policy*

Interest on loans is credited to income as earned and is accrued only if deemed collectible. Accrual of interest is discontinued when a loan is over 90 days delinquent or if management believes that collection is highly uncertain. Generally, payments received on non-accrual loans are recorded as principal reductions. Interest income is recognized after all principal has been repaid or an improvement in the condition of the loan has occurred that would warrant resumption of interest accruals. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due.

#### *Asset Impairment Judgments*

Certain of our assets are carried in our consolidated balance sheets at fair value or at the lower of cost or fair value. Valuation allowances are established when necessary to recognize impairment of such assets. We periodically perform analyses to test for impairment of various assets. In addition to our impairment analyses related to loans, another significant impairment analysis relates to other than temporary declines in the value of our securities.

Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired and are carried at fair value or below. Appraisals are done periodically on impaired loans and if required an allowance is established based on the fair value of collateral less the cost related to liquidation of the collateral. In some circumstances, an impaired loan may be charged off to bring the carrying value to fair value.



Other real estate assets (“OREO”) acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses, subsequent to foreclosure. Appraisals or evaluations are then done periodically and any subsequent declines in the fair value of the OREO property after the date of transfer are recorded through a write-down of the asset. Any subsequent operating expenses or income, reduction in estimated fair values, and gains or losses on disposition of such properties are charged or credited to current operations.

Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as type, leasing status and physical condition. When the appraisals are received, Management reviews the assumptions and methodology utilized in the appraisal, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by management on a case-by-case basis.

Our available for sale portfolio is carried at estimated fair value, with any unrealized gains and losses, net of taxes, reported as accumulated other comprehensive income in shareholders’ equity. We conduct a periodic review and evaluation of the securities portfolio to determine if the value of any security has declined below its carrying value and whether such decline is other than temporary. If such decline is deemed other than temporary, we would adjust the carrying amount of the security by writing down the security to fair market value through a charge to current period income. The market values of our securities are significantly affected by changes in interest rates.

In general, as interest rates rise, the market value of fixed-rate securities will decrease; as interest rates fall, the market value of fixed-rate securities will increase. With significant changes in interest rates, we evaluate our intent and ability to hold the security for a sufficient time to recover the recorded principal balance. Estimated fair values for securities are based on published or securities dealers’ market values. Market volatility is unpredictable and may impact such values.

#### *Fair Value Measurements*

We use fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. We base our fair values on the price that would be received to sell an asset or paid to transfer a

liability in an orderly transaction between market participants at the measurement date. Securities available for sale, derivatives, and loans held for sale, if any, are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record certain assets at fair value on a non-recurring basis, such as certain impaired loans held for investment and securities held to maturity that are other-than-temporarily impaired. These non-recurring fair value adjustments typically involve write-downs of individual assets due to application of lower-of-cost or market accounting.

We have established and documented a process for determining fair value. We maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. Whenever there is no readily available market data, management uses its best estimate and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial statements.

#### *Business combinations and related matters*

Business combinations are accounted for under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*. Under the acquisition method the acquiring entity in a business combination recognizes 100 percent of the acquired assets and assumed liabilities, regardless of the percentage owned, at their estimated fair values as of the date of acquisition. Any excess of the purchase price over the fair value of net assets and other identifiable intangible assets acquired is recorded as goodwill. Assets acquired and liabilities assumed from contingencies must also be recognized at fair value, if the fair value can be determined during the measurement period. Results of operations of an acquired business are included in the statement of operations from the date of acquisition. Acquisition-related costs, including conversion charges, are expensed as incurred. The Company applied this guidance to the acquisition of Mother Lode Bank that was consummated on December 23, 2015.

#### *Income Taxes*

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled using the liability method. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company files income tax returns in the U.S. federal jurisdiction, and the state of California. With few exceptions, the Company is no longer subject to U.S. federal or state/local income tax examinations by tax authorities for years before 2011.

## **Introduction**

Effective July 3, 2008, Oak Valley Community Bank became a subsidiary of Oak Valley Bancorp, a newly established bank holding company. Oak Valley Bancorp operates Oak Valley Community Bank as a community bank in the general commercial banking business, with our primary market encompassing the California Central Valley around Oakdale and Modesto, and the Eastern Sierras. As such, unless otherwise noted, all references are about Oak Valley Bancorp.

Oak Valley Community Bank commenced operations in May 1991. We are an insured bank under the Federal Deposit Insurance Act and are a member of the Federal Reserve. Since its formation, the Bank has provided basic banking services to individuals and business enterprises in Oakdale, California and the surrounding areas. The focus of the Bank is to offer a range of commercial banking services designed for both individuals and small to medium-sized businesses in the two main areas of service of the Company: the Central Valley and the Eastern Sierras.

The Bank offers a complement of business checking and savings accounts for its business customers. The Bank also offers commercial and real estate loans, as well as lines of credit. Real estate loans are generally of a short-term nature for both residential and commercial purposes. Longer-term real estate loans are generally made with adjustable interest rates and contain normal provisions for acceleration. In addition, the Bank offers traditional residential mortgages through a third party.

The Bank also offers other services for both individuals and businesses including online banking, remote deposit capture, merchant services, night depository, extended hours, traveler's checks, wire transfer of funds, note collection, and automated teller machines in a national network. The Bank does not currently offer international banking or trust services although the Bank may make such services available to the Bank's customers through financial institutions with which the Bank has correspondent banking relationships. The Bank does not offer stock transfer services nor does it directly issue credit cards.



## Overview of Results of Operations and Financial Condition

The purpose of this summary is to provide an overview of the items management focuses on when evaluating the condition of the Company and its success in implementing its business and shareholder value strategies. The Company's business strategy is to operate the Bank as a well-capitalized, profitable and independent community oriented bank. The Company's shareholder value strategy has three major objectives: (1) enhancing shareholder value; (2) making its retail banking franchise more valuable; and (3) efficiently utilizing its capital.

Management believes the following were important factors in the Company's performance during the three and six month periods ended June 30, 2016:

The Company recognized net income of \$1,904,000 and \$3,413,000 for the three and six month periods ended June 30, 2016, respectively, as compared to \$1,510,000 and \$3,036,000 for the same periods in 2015. The factors contributing to these results will be discussed below.

The Company recognized loan loss provisions of \$125,000 and \$325,000, during the three and six month periods ended June 30, 2016, respectively, primarily due to strong loan growth. This compares to no provisions during the second quarter of 2015, and a \$125,000 reversal of loan loss provisions during the six month period of 2015 due to a pay-off received on an impaired loan.

Net interest income increased \$1,906,000 or 30.7% and \$3,247,000 or 26.2% for the three and six month periods ended June 30, 2016, respectively, compared to the same periods in 2015. The increase was primarily due to the organic growth of our loan and investment security portfolios, and the \$42,831,000 in loans acquired from the Mother Lode Bank acquisition.

Non-interest income decreased by \$100,000 or 8.7% and \$90,000 or 4.1% for the three and six months ended June 30, 2016, respectively, as compared to the same periods in 2015. The decrease was primarily from a reduction in non-recurring gains on called investment securities and FHLB dividend income which was offset in part by the incremental service charge fee income recognized on the Mother Lode Bank deposit accounts.

Non-interest expense increased by \$994,000 or 19.1% and \$2,083,000 or 20.2% for the three and six month periods ended June 30, 2016, respectively, as compared to the same periods in 2015. The increase was mainly due to an increase in staffing necessary to support the loan and deposit growth and the opening of our Sonora branch in December 2015.

Total assets increased \$28,597,000 or 3.2% from December 31, 2015. Total net loans increased by \$39,274,000 or 7.4% and investment securities increased by \$18,753,000 or 14.3% from December 31, 2015 to June 30, 2016, while deposits increased by \$23,767,000 or 2.9% for the same period.



## Income Summary

For the three and six month periods ended June 30, 2016, the Company recorded net income of \$1,904,000 and \$3,413,000, respectively, representing increases of \$394,000 and \$377,000, respectively, as compared to the same periods in 2015. Return on average assets (annualized) was 0.85% and 0.76% for the three and six months ended June 30, 2016, respectively, as compared to 0.81% for the same periods in 2015. Annualized return on average common equity was 9.48% and 8.08% for the three and six months ended June 30, 2016, respectively, as compared to 7.94% and 8.08% for the same periods of 2015.

Net income before provisions for income taxes increased \$687,000 and \$624,000 for the three and six month periods ended June 30, 2016, respectively, from the comparable 2015 periods. The income statement components of these variances are as follows:

### *Pre-Tax Income Variance Summary:*

	<b>Effect on Pre-Tax Income</b>	<b>Effect on Pre-Tax Income</b>
<i>(In thousands)</i>	<i>Increase (Decrease)</i>	<i>Increase (Decrease)</i>
	<b>Three Months Ended</b>	<b>Six Months Ended</b>
	<b>June 30, 2016</b>	<b>June 30, 2016</b>
Change from 2015 to 2016 in:		
Net interest income	\$ 1,906	\$ 3,247
Provision for loan losses	(125 )	(450 )
Non-interest income	(100 )	(90 )
Non-interest expense	(994 )	(2,083 )
Change in net income before income taxes	\$ 687	\$ 624

These variances will be explained in the discussion below.

## **Net Interest Income**

Net interest income is the largest source of the Company's operating income. For the three and six month periods ended June 30, 2016, net interest income was \$8,106,000 and \$15,648,000, respectively, which represented increases of \$1,906,000 or 30.7% and \$3,247,000 or 26.2% from the comparable periods in 2015. The increase is primarily due to organic loan growth in addition to the revenue recognized from loans and deposits acquired from Mother Lode Bank. Further, the Company recognized accretion of \$550,000 and \$723,000 during the three and six month periods ended June 30, 2016, respectively, on the fair value discount of the acquired loans, which is included in the net interest income totals.

The net interest margin (net interest income as a percentage of average interest earning assets) was 4.03% and 3.90% for the three and six month periods ended June 30, 2016, respectively, which increased compared to 3.70% and 3.72% for the same periods in 2015, mainly due to the loan discount accretion as discussed above. Overall, the Company has experienced net interest margin compression since the economic downturn in 2010 for several reasons: 1) deposit interest rates have essentially reached a threshold in which they cannot reasonably be further reduced, 2) competition in the lending market has driven new loan rates down, 3) loan and investment portfolio yields continue to decrease due to contractual repricing and 4) deposit growth has out-paced loan growth and the elevated interest-bearing cash balances, which yield approximately 0.50%, have compressed our net interest margin. Despite these factors, the net interest margin has stabilized over the past three quarters due to a shift in the earning asset mix from cash balances into new loan fundings and investment security purchases that earn a higher yield despite the continued compression of loan and investment yields.

Earning asset yield increased by 35 and 17 basis points for the three and six month periods ended June 30, 2016, respectively, compared to the same periods of 2015, mainly due to the loan discount accretion as discussed above. Overall, the yield on loans has begun to stabilize due to the positive impact of the December 2015 interest rate hike on floating rate loans, which combined with the loan discount accretion, resulted in loan yield increases of 24 and 9 basis points for the second quarter and six month period of 2016, respectively, as compared to 2015. Furthermore, the Company has deployed a significant portion of the low yielding cash equivalent balances into the loan and investment portfolios which recognized average balance increases of \$108.2 million and \$17.9 million, respectively, in the six month period of 2016 as compared to 2015.

The cost of funds on interest-bearing liabilities remained flat at 0.13% for the three and six months ended June 30, 2016 and 2015, as deposit rates remain at historic lows and have essentially reached a floor whereby further reductions are not feasible. The Company continues to recognize strong core deposit growth as evidenced by the increase in average non-interest-bearing demand deposit balances of \$49.7 million and \$49.3, for the three and six month periods ended June 30, 2016, respectively, as compared to the same period of 2015, much of which was a result of the accounts acquired from Mother Lode Bank.



The following tables shows the relative impact of changes in average balances of interest earning assets and interest bearing liabilities, and interest rates earned and paid by the Company on those assets and liabilities for the three and six month periods ended June 30, 2016 and 2015:

**Net Interest Analysis**

	Three Months Ended June 30, 2016			Three Months Ended June 30, 2015		
	Average Balance	Interest Income / Expense	Avg Rate/ Yield	Average Balance	Interest Income / Expense	Avg Rate/ Yield
<i>(in thousands)</i>						
<b>Assets:</b>						
Earning assets:						
Gross loans (1) (2)	\$573,298	\$ 7,133	4.99 %	\$453,835	\$ 5,377	4.75 %
Investment securities (2)	143,069	1,272	3.57 %	126,495	1,124	3.56 %
Federal funds sold	4,216	5	0.48 %	16,072	9	0.22 %
Interest-earning deposits	111,314	147	0.53 %	101,174	72	0.29 %
Total interest-earning assets	831,897	8,557	4.13 %	697,576	6,582	3.78 %
Total noninterest earning assets	71,675			54,619		
Total Assets	903,572			752,195		
<b>Liabilities and Shareholders' Equity:</b>						
Interest-bearing liabilities:						
Interest-earning DDA	22,031	2	0.04 %	15,563	1	0.03 %
Money market deposits	287,389	81	0.11 %	265,933	69	0.10 %
NOW deposits	150,670	37	0.10 %	109,624	19	0.07 %
Savings deposits	72,009	29	0.16 %	47,554	14	0.12 %
Time certificates of deposit \$250,000 or more	17,599	12	0.27 %	10,166	7	0.28 %
Other time deposits	33,519	30	0.36 %	37,319	45	0.48 %
Other borrowings	0	0	0.00 %	20	0	0.00 %
Total interest-bearing liabilities	583,217	191	0.13 %	486,179	155	0.13 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	235,651			185,994		
Other liabilities	4,153			3,774		
Total noninterest-bearing liabilities	239,804			189,768		
Shareholders' equity	80,551			76,248		
Total liabilities and shareholders' equity	\$903,572			\$752,195		
Net interest income		\$ 8,366			\$ 6,427	
Net interest spread (3)			3.99 %			3.66 %
Net interest margin (4)			4.03 %			3.70 %

- (1) Loan fees have been included in the calculation of interest income.*
- (2) Yields and interest income on municipal securities and loans have been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.*
- (3) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.*
- (4) Represents net interest income as a percentage of average interest-earning assets.*
- (5) Annual interest rates are computed by dividing the interest income/expense by the number of days in the period multiplied by 365.*

	Six months ended			Six months ended		
	June 30, 2016			June 30, 2015		
(in thousands)	Average Balance	Interest Income / Expense	Avg Rate/ Yield	Average Balance	Interest Income / Expense	Avg Rate/ Yield
<b>Assets:</b>						
Earning assets:						
Gross loans (1) (2)	\$563,173	\$ 13,684	4.87 %	\$454,973	\$ 10,781	4.78 %
Investment securities (2)	140,273	2,500	3.57 %	122,418	2,206	3.63 %
Federal funds sold	5,999	15	0.50 %	14,279	17	0.24 %
Interest-earning deposits	122,266	323	0.53 %	104,824	139	0.27 %
Total interest-earning assets	831,711	16,522	3.98 %	696,494	13,143	3.81 %
Total noninterest earning assets	70,711			57,297		
Total assets	902,422			753,791		
<b>Liabilities and Shareholders' Equity:</b>						
Interest-bearing liabilities:						
Interest-earning DDA	21,212	4	0.04 %	15,757	3	0.04 %
Money market deposits	289,597	159	0.11 %	261,011	138	0.11 %
NOW deposits	140,980	60	0.09 %	110,326	37	0.07 %
Savings deposits	73,196	54	0.15 %	44,947	25	0.11 %
Time certificates of deposit \$250,000 or more	17,558	26	0.30 %	10,162	16	0.32 %
Other time deposits	33,129	56	0.34 %	37,854	88	0.47 %
Other borrowings	19	0	0.00 %	24	0	0.00 %
Total interest-bearing liabilities	575,691	359	0.13 %	480,081	307	0.13 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	242,942			193,623		
Other liabilities	4,090			4,325		
Total noninterest-bearing liabilities	247,032			197,948		
Shareholders' equity	79,699			75,762		
Total liabilities and shareholders' equity	\$902,422			\$753,791		
Net interest income		\$ 16,163			\$ 12,836	
Net interest spread (3)			3.86 %			3.68 %
Net interest margin (4)			3.90 %			3.72 %

(1) Loan fees have been included in the calculation of interest income.



*(2) Yields and interest income on municipal securities and loans have been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.*

*(3) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.*

*(4) Represents net interest income as a percentage of average interest-earning assets.*

*(5) Annual interest rates are computed by dividing the interest income/expense by the number of days in the period multiplied by 365.*

Shown in the following tables are the relative impacts on net interest income of changes in the average outstanding balances (volume) of earning assets and interest bearing liabilities and the rates earned and paid by the Company on those assets and liabilities for the three and six month periods ended June 30, 2016 and 2015. Changes in interest income and expense that are not attributable specifically to either rate or volume are allocated to the rate column below.

### *Rate / Volume Variance Analysis*

*(In thousands)*

	<b>For the Three Months Ended</b>		
	<b>June 30, 2016 vs 2015</b>		
<i>(in thousands)</i>	<b>Increase (Decrease)</b>		
	<b>in interest income and expense</b>		
	<b>due to changes in:</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Total</b>
<b>Interest income:</b>			
Gross loans (1) (2)	\$1,415	\$341	\$1,756
Investment securities (2)	147	1	148
Federal funds sold	(7 )	3	(4 )
Interest-earning deposits	7	68	75
<b>Total interest income</b>	<b>\$1,562</b>	<b>\$413</b>	<b>\$1,975</b>
<b>Interest expense:</b>			
Interest-earning DDA	0	1	1
Money market deposits	6	6	12
NOW deposits	7	11	18
Savings deposits	7	8	15
Time CD \$100K or more	5	0	5
Other time deposits	(5 )	(10 )	(15 )
Other borrowings	0	0	0
<b>Total interest expense</b>	<b>\$20</b>	<b>\$16</b>	<b>\$36</b>
<b>Change in net interest income</b>	<b>\$1,542</b>	<b>\$397</b>	<b>\$1,939</b>

*(1) Loan fees have been included in the calculation of interest income.*

*(2) Interest income on municipal securities and loans has been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.*

The table above reflects how the loan discount accretion of \$550,000 impacted the loan yields and the interest rate hike in December 2015 has impacted interest-earning cash balances as indicated by the increase of \$397,000 in net interest income due to rate changes for the second quarter of 2016. The increase in earning asset balances combined with the overall change in mix of balances resulted in an increase of \$1,542,000 to net interest income over the same period.

**For the Six Months  
Ended June 30,**

**2016 vs 2015**

(in thousands)

**Increase (Decrease)**

**in interest income and  
expense**

**due to changes in:**

**Volume Rate Total**

**Interest income:**

Gross loans (1) (2)	\$2,564	\$339	\$2,903
Investment securities (2)	322	(28 )	294
Federal funds sold	(10 )	8	(2 )
Interest-earning deposits	23	161	184
<b>Total interest income</b>	<b>\$2,899</b>	<b>\$480</b>	<b>\$3,379</b>

**Interest expense:**

Interest-earning DDA	\$1	\$-	\$1
Money market deposits	15	6	21
NOW deposits	10	13	23
Savings deposits	16	13	29
Time CD \$250K or more	12	(2 )	10
Other time deposits	(11 )	(21 )	(32 )
Other borrowings	0	0	0
<b>Total interest expense</b>	<b>\$43</b>	<b>\$9</b>	<b>\$52</b>

**Change in net interest income**    **\$2,856**    **\$471**    **\$3,327**

(1) Loan fees have been included in the calculation of interest income.

(2) Interest income on municipal securities and loans has been adjusted to their fully-taxable equivalents, based on a federal marginal tax rate of 34.0%.

The table above reflects how the loan discount accretion of \$723,000 impacted the loan yields and the interest rate hike in December 2015 has impacted interest-earning cash balances as indicated by the increase of \$471,000 in net interest income due to rate changes for the first six months of 2016. The increase in earning asset balances combined with the overall change in mix of balances resulted in an increase of \$2,856,000 to net interest income over the same period.

**Non-Interest Income**

Non-interest income represents service charges on deposit accounts and other non-interest related charges and fees, including fees from mortgage commissions and investment service fee income. For the three and six month periods ended June 30, 2016, non-interest income was \$1,056,000 and \$2,093,000, respectively, representing decreases of \$100,000 or 1.0% and \$90,000 or 4.1%, compared to the same periods in 2015.

The following tables show the major components of non-interest income:

(in thousands)	<b>For the Three Months Ended June 30,</b>			
	<b>2016</b>	<b>2015</b>	<b>\$ change</b>	<b>% change</b>
Service charges on deposits	\$337	\$308	\$ 29	9.4 %
Earnings on cash surrender value of life insurance	95	106	(11 )	(10.4%)
Mortgage commissions	49	42	7	16.7 %
Gains on calls and sales of securities	12	73	(61 )	(83.6%)
Other income	563	627	(64 )	(10.2%)
Total non-interest income	\$1,056	\$1,156	\$ (100 )	(8.7% )

(in thousands)	For the Six Months Ended June 30,			
	2016	2015	\$ change	% change
Service charges on deposits	\$670	\$620	\$ 50	8.1 %
Earnings on cash surrender value of life insurance	203	214	(11 )	(5.1% )
Mortgage commissions	95	88	7	8.0 %
Net gain on sales and calls of securities	18	182	(164 )	(90.1%)
Other income	1,107	1,079	28	2.6 %
Total non-interest income	\$2,093	\$2,183	\$ (90 )	(4.1% )

Service charges on deposits increased by \$29,000 and \$50,000 for the three and six months ended June 30, 2016, respectively, compared to the same periods in 2015, partially as a result of the deposit accounts acquired from Mother Lode Bank.

Mortgage commissions increased by \$7,000 for the three and six months ended June 30, 2016, as compared to the same periods of 2015, as the demand for home purchases and refinancing has stabilized.

Net gain on sales and calls of securities decreased by \$63,000 and \$164,000 in the second quarter and six month period of 2016, respectively, as compared to the same periods in 2015, mainly due to a large nonrecurring call of one security recorded last year.

Other income decreased by \$64,000 for the three month period ended June 30, 2016, and increased by \$28,000 for the six month period of 2016, as compared to the same periods of 2015. The second quarter decrease is mainly a result of the a large one-time FHLB dividend that was recorded in the second quarter of 2015, which was offset in part by transaction based fee income as the number of transaction deposit accounts has increased.

### Non-Interest Expense

Non-interest expense represents salaries and benefits, occupancy expenses, professional expenses, outside services, and other miscellaneous expenses necessary to conduct business.

The following tables show the major components of non-interest expenses:

(in thousands)	<b>For the Three Months Ended June 30,</b>			
	<b>2016</b>	<b>2015</b>	<b>\$ change</b>	<b>% change</b>
Salaries and employee benefits	\$3,370	\$2,955	\$ 415	14.0 %
Occupancy	813	724	89	12.3 %
Data processing fees	440	358	82	22.9 %
Regulatory assessments (FDIC & DBO)	170	131	39	29.8 %
Other	1,394	1,025	369	36.0 %
Total non-interest expense	\$6,187	\$5,193	\$ 994	19.1 %

(in thousands)	<b>For the Six Months Ended June 30,</b>			
	<b>2016</b>	<b>2015</b>	<b>\$ change</b>	<b>% change</b>
Salaries and employee benefits	\$6,725	\$5,938	\$ 787	13.3 %
Occupancy	1,651	1,471	180	12.2 %
Data processing fees	911	711	200	28.1 %
Regulatory assessments (FDIC & DBO)	327	245	82	33.5 %
Other	2,760	1,926	834	43.3 %
Total non-interest expense	\$12,374	\$10,291	\$ 2,083	20.2 %

Non-interest expenses increased by \$994,000 or 19.1% and \$2,083,000 or 20.2% for the three and six months ended June 30, 2016, respectively, as compared to the same periods of 2015. Salaries and employee benefits increased \$415,000 and \$787,000 for the three and six months ended June 30, 2016, respectively, as compared to the same periods of 2015, primarily due to additional staffing required to support the continued loan and deposit growth and the opening of our Sonora branch in December 2015.

Occupancy expenses increased by \$89,000 and \$180,000 for the three and six months ended June 30, 2016, respectively, as compared to the same periods of 2015, which is primarily due to the rent expense and general overhead associated with the Sonora branch which opened in December 2015. Data processing fees increased by \$82,000 and \$200,000 for the three and six month periods ended June 30, 2016, respectively, as a result of an increased number of transaction accounts including the accounts acquired from Mother Lode Bank.

FDIC and DBO (California Department of Business Oversight) regulatory assessments increased by \$39,000 and \$82,000 for the three and six months ended June 30, 2016, respectively, as compared to the same periods in 2015. The initial base assessment rate for financial institutions varies based on the overall risk profile of the institution as defined by the FDIC. The assessment rate remained at a relatively lower level than peer institutions due to our stable risk profile, but was offset by a higher deposit base in 2016 as compared to 2015, as the FDIC assessment rates are applied to average quarterly total liabilities as the primary basis.

Other expense increased by \$369,000 and \$834,000 for the three and six months ended June 30, 2016, respectively, compared to the same periods in 2015, mainly as a result of a \$193,000 recovery of impaired loan expense recorded during the first quarter of 2015, corresponding to the payoff of a non-performing loan. Also included in other expense during the six month period ended June 30, 2016, were related merger expenses and core deposit intangible amortization associated with the Mother Lode Bank acquisition totaling \$141,000 and \$81,000, respectively.

Management anticipates that non-interest expense will continue to increase as we continue to grow. However, management remains committed to cost-control and efficiency, and we expect to keep these increases to a minimum relative to growth.

## **Income Taxes**

We reported provisions for income taxes of \$946,000 and \$1,629,000 for the three and six month periods ended June 30, 2016, respectively, representing increases of \$293,000 and \$247,000 as compared to the provisions reported in the comparable periods of 2015. The effective income tax rates on income from continuing operations was 33.2% and 32.3% for the three and six months ended June 30, 2016, respectively, compared to 30.2% and 31.3% for the comparable periods of 2015. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, BOLI and certain tax-exempt loans). The disparity between the effective tax rates for 2016 as compared to 2015 is primarily due to tax credits from California Enterprise Zones and low income housing projects as well as tax free-income on loans within these enterprise zones and municipal securities and loans that comprise a larger proportion of pre-tax income in 2015 as compared to 2016.



## Asset Quality

Non-performing assets consist of loans on non-accrual status, including loans restructured on non-accrual status, where the terms of repayment have been renegotiated resulting in a reduction or deferral of interest or principal, loans 90 days or more past due and still accruing interest and other real estate owned (“OREO”).

Loans are generally placed on non-accrual status when they become 90 days past due, unless management believes the loan is adequately collateralized and in the process of collection. The past due loans may or may not be adequately collateralized, but collection efforts are continuously pursued. Loans may be restructured by management when a borrower has experienced some changes in financial status, causing an inability to meet the original repayment terms, and where we believe the borrower will eventually overcome those circumstances and repay the loan in full. OREO consists of properties acquired by foreclosure or similar means and which management intends to offer for sale.

Non-accrual loans totaled \$2.65 million at June 30, 2016, as compared to \$5.82 million at December 31, 2015. The non-accrual loans as of June 30, 2016 are loans made to three borrowers primarily for purposes of residential real estate development. As of June 30, 2016, we had five loans considered troubled debt restructurings totaling \$2.65 million, all of which are included in non-accrual loans.

OREO as of June 30, 2016 consisted of three properties, one of which was a residential land acquired through foreclosure that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. The other OREO assets consisted of a residential property totaling \$956,000 that was acquired through foreclosure and one residential land property with a balance of \$275,000 that was acquired from Mother Lode Bank.

The following table presents information about the Bank's non-performing assets, including asset quality ratios as of June 30, 2016 and December 31, 2015:

***Non-Performing Assets***

<i>(in thousands)</i>	<b>June 30,</b>	<b>December 31,</b>		
	<b>2016</b>	<b>2015</b>		
Loans in non-accrual status	\$2,654	\$ 5,816		
Loans past due 90 days or more and accruing	0	0		
Total non-performing loans	2,654	5,816		
Other real estate owned	1,231	2,066		
Total non-performing assets	\$3,885	\$ 7,882		
Allowance for loan losses	\$7,680	\$ 7,534		
Asset quality ratios:				
Non-performing assets to total assets	0.42 %	0.88 %		
Non-performing loans to total loans	0.46 %	1.07 %		
Allowance for loan losses to total loans	1.32 %	1.36 %		
Allowance for loan losses to total non-performing loans	289.4 %	126.5 %		

Non-performing assets decreased by \$3,997,000 as of June 30, 2016, as compared to December 31, 2015, as a result of 3 loans from one borrower totaling \$3,886,000 that were paid off which are included in the total principal payments of \$4,299,000 during the first six months of 2016. The Company also sold two OREO properties for total proceeds of \$746,000, which resulted in a loss on sale of \$88,000. There were no fair value adjustments to OREO properties during the first six months of 2016.

***Allowance for Loan and Lease Losses (“ALLL”)***

Due to credit risk inherent in our lending business, we routinely set aside allowances through charges to earnings. Such charges are not only made for the outstanding loan portfolio, but also for off-balance sheet items, such as commitments to extend credits or letters of credit. Charges made for the outstanding loan portfolio have been credited to the allowance for loan losses, whereas charges for off-balance sheet items have been credited to the reserve for

off-balance sheet items, which is presented as a component of other liabilities. The Company recorded loan loss provisions of \$125,000 and \$325,000 during the three and six months ended June 30, 2016, respectively, compared to no provisions during the second quarter of 2015 and a \$125,000 reversal of loan loss provisions for the six months ended June 30, 2015.

The allowance for loan losses increased by \$324,000 or 4.4%, to \$7,680,000 at June 30, 2016, as compared to \$7,356,000 at December 31, 2015. The Company recognized the increase in the allowance for loan losses during the first six months of the year due to the \$325,000 loan loss provision as previously described, and the net loan charge-off of \$1,000. The increase to the allowance for loan losses was outpaced by the increase in gross loans resulting in a decrease in the allowance for loan losses as a percentage of total loans to 1.32% at June 30, 2016, as compared to 1.36% at December 31, 2015.

The Company will continue to monitor the adequacy of the allowance for loan losses and make additions to the allowance in accordance with the analysis referred to above. Because of uncertainties inherent in estimating the appropriate level of the allowance for loan losses, actual results may differ from management's estimate of credit losses and the related allowance.

The Company makes provisions for loan losses when required to bring the total allowance for loan and lease losses to a level deemed appropriate for the level of risk in the loan portfolio. At least quarterly, management conducts an assessment of the overall quality of the loan portfolio and general economic trends in the local market. The determination of the appropriate level for the allowance is based on that review, considering such factors as historical experience, the volume and type of lending conducted, the amount of and identified potential loss associated with specific non-performing loans, regulatory policies, general economic conditions, and other factors related to the collectability of loans in the portfolio.

Although management believes the allowance at June 30, 2016 was adequate to absorb probable losses from any known and inherent risks in the portfolio, no assurance can be given that the adverse effect of current and future economic conditions on our service areas, or other variables, will not result in increased losses in the loan portfolio in the future.

## **Investment Activities**

Investments are a key source of interest income. Management of our investment portfolio is set in accordance with strategies developed and overseen by our Investment Committee. Investment balances, including cash equivalents and interest-bearing deposits in other financial institutions, are subject to change over time based on our asset/liability funding needs and interest rate risk management objectives. Our liquidity levels take into consideration anticipated future cash flows and all available sources of credits, and are maintained at levels management believes are

appropriate to assure future flexibility in meeting anticipated funding needs.

### *Cash Equivalents*

The Company holds federal funds sold, unpledged available-for-sale securities and salable government guaranteed loans to help meet liquidity requirements and provide temporary holdings until the funds can be otherwise deployed or invested. As of June 30, 2016, and December 31, 2015, we had \$162,624,000 and \$190,603,000, respectively, in cash and cash equivalents.

### *Investment Securities*

Management of our investment securities portfolio focuses on providing an adequate level of liquidity and establishing an interest rate-sensitive position, while earning an adequate level of investment income without taking undue risk. Investment securities that we intend to hold until maturity are classified as held-to-maturity securities, and all other investment securities are classified as available-for-sale. Currently, all of our investment securities are classified as available-for-sale. The carrying values of available-for-sale investment securities are adjusted for unrealized gains or losses as a valuation allowance and any gain or loss is reported on an after-tax basis as a component of other comprehensive income.

Management has evaluated the investment securities portfolio to determine if the impairment of any security in an unrealized loss position is temporary or other than temporary. We conduct a periodic review and evaluation of the securities portfolio to determine if the value of any security has declined below its carrying value. If such decline is deemed other than temporary, we would adjust the carrying amount of the security by writing down the security to fair value through a charge to current period income or a charge to accumulated other comprehensive income depending on the nature of the impairment and managements intent or requirement to sell the security. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes.

### **Deposits**

Total deposits at June 30, 2016 were \$838,458,000, a \$23,767,000 or 2.9% increase from the deposit total of \$814,691,000 at December 31, 2015. Average deposits increased \$144,934,000 to \$818,614,000 for the six month period ended June 30, 2016 as compared to the same period in 2015, due in part to the \$71,125,000 acquired from Mother Lode Bank in December 2015. We attracted deposits due to the safety and soundness of the Bank and our focus on customer service.

**Deposits Outstanding**

	<b>June 30,</b>	<b>December</b>	<b>Six month</b>	
<i>(in thousands)</i>	<b>2016</b>	<b>31,</b>	<b>change</b>	
		<b>2015</b>	<b>\$</b>	<b>%</b>
Demand	\$266,036	\$279,367	\$(13,331)	(4.8%)
NOW	163,391	130,674	32,717	25.0 %
MMDA	285,263	282,449	2,814	1.0 %
Savings	71,607	71,627	(20 )	(0.0%)
Time < \$250K	34,532	35,482	(950 )	(2.7%)
Time > \$250K	17,629	15,092	2,537	16.8 %
	<b>\$838,458</b>	<b>\$814,691</b>	<b>\$23,767</b>	<b>2.9 %</b>

Because our client base is comprised primarily of commercial and industrial accounts, individual account balances are generally higher than those of consumer-oriented banks. Four of our clients carry deposit balances of more than 1% of our total deposits, one of which had a deposit balance of more than 3% of total deposits at June 30, 2016.

Since our deposit growth strategy emphasizes core deposit growth we have avoided relying on brokered deposits as a consistent source of funds. The Company had \$50,000 and \$1,001,000 in brokered deposits as of June 30, 2016 and December 31, 2015, respectively. The only brokered deposits the Bank holds are from CDARS and ICS, a certificate of deposit and money market account program, respectively, that exchanges funds with other network banks to offer full FDIC insurance coverage to the customer.

**Borrowings**

Although deposits are the primary source of funds for our lending and investment activities and for general business purposes, we may obtain advances from the Federal Home Loan Bank of San Francisco (“FHLB”) as an alternative to retail deposit funds. Our outstanding FHLB advances remained a zero balance at December 31, 2015 and June 30, 2016, as we continue to rely on deposit growth as our primary source of funding. See “Liquidity Management” below for the details on the FHLB borrowings program.



## Capital Ratios

The Company is regulated by the Board of Governors of the Federal Reserve Board (FRB) and is subject to the securities registration and public reporting regulations of the Securities and Exchange Commission. As a California-state chartered bank, our banking subsidiary is subject to primary supervision, examination and regulation by the California Department of Business Oversight (DBO) and the Federal Reserve Board. The Federal Reserve Board is the primary federal regulator of state member banks. The Bank is also subject to regulation by the FDIC, which insures the Bank's deposits as permitted by law. We are not aware of any recommendations of regulatory authorities or otherwise which, if they were to be implemented, would have a material effect on our liquidity, capital resources, or operations.

The Company must comply with regulatory capital requirements established by the FRB. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. These capital standards require us to maintain minimum ratios of "Tier 1" capital to total risk-weighted assets and total capital to risk-weighted assets of 6.00% and 8.00%, respectively. Tier 1 capital is comprised of total shareholders' equity calculated in accordance with generally accepted accounting principles, excluding accumulated other comprehensive income (loss), less intangible assets, and total capital is comprised of Tier 1 capital plus certain adjustments, the largest of which is our allowance for loan losses. Risk-weighted assets refer to our on- and off-balance sheet exposures, adjusted for their related risk levels using formulas set forth in FRB and FDIC regulations.

In addition to the risk-based capital requirements described above, we are subject to a leverage capital requirement, which calls for a minimum ratio of Tier 1 capital (as defined above) to quarterly average total assets of 4.00%.

In July 2013, the U.S. banking agencies approved the U.S. version of Basel III. The federal bank regulatory agencies adopted version of Basel III revises the risk-based and leverage capital requirements and the method for calculating risk-weighted assets to make them consistent with Basel III and to meet the requirements of the Dodd-Frank Act. Although many of the rules contained in these final regulations are applicable only to large, internationally active banks, some of them will apply on a phased in basis to all banking organizations, including the Company and the Bank. Among other things, the rules establish a new minimum common equity Tier 1 ratio (4.5% of risk-weighted assets), a higher minimum Tier 1 risk-based capital requirement (6.0% of risk-weighted assets) and a minimum non-risk-based leverage ratio (4.00% eliminating a 3.00% exception for higher rated banks). The new additional capital conservation buffer of 2.5% of risk weighted assets over each of the required capital ratios will be phased in from 2016 to 2019 and must be met to avoid limitations on the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses. The additional "countercyclical capital buffer" is also required for larger and more complex institutions. The new rules assign higher risk weighting to exposures that are more than 90 days past due or



are on nonaccrual status and certain commercial real estate facilities that finance the acquisition, development or construction of real property. The rules also change the permitted composition of Tier 1 capital to exclude trust preferred securities, mortgage servicing rights and certain deferred tax assets and include unrealized gains and losses on available for sale debt and equity securities (with a one-time opt out option for Standardized Banks (banks with less than \$250 billion of total consolidated assets and less than \$10 billion of foreign exposures)). The rules, including alternative requirements for smaller community financial institutions like the Company, would be phased in through 2019. The implementation of the Basel III framework for the Company and the Bank commenced on January 1, 2015.

Failure to meet minimum capital requirements can trigger regulatory actions that could have a material adverse effect on our financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that rely on quantitative measures of our assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The following table shows our capital ratios, as calculated under regulatory guidelines, compared to the regulatory minimum capital ratios and the regulatory minimum capital ratios needed to qualify as a “well-capitalized” institution at June 30, 2016 and December 31, 2015:

<i>(in thousands)</i>	<b>Actual</b>		<b>For capital adequacy purposes</b>		<b>To be well capitalized under prompt corrective action provisions</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b>Capital ratios for Bank:</b>						
As of June 30, 2016						
Total capital (to Risk- Weighted Assets)	\$84,376	11.7 %	\$62,156	≥8.625%	\$72,065	≥10.0%
Tier I capital (to Risk- Weighted Assets)	\$76,439	10.6 %	\$47,743	≥6.625%	\$57,652	≥8.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$76,439	10.6 %	\$36,933	≥5.515%	\$46,842	≥6.5%
Tier I capital (to Average Assets)	\$76,439	8.5 %	\$36,042	≥4.0%	\$45,052	≥5.0%
As of December 31, 2015						
Total capital (to Risk- Weighted Assets)	\$81,462	12.2 %	\$53,348	≥8.0%	\$66,685	≥10.0%
Tier I capital (to Risk- Weighted Assets)	\$73,868	11.1 %	\$40,011	≥6.0%	\$53,348	≥8.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$73,868	11.1 %	\$30,008	≥4.5%	\$43,345	≥6.5%
Tier I capital (to Average Assets)	\$73,868	9.1 %	\$32,475	≥4.0%	\$40,593	≥5.0%
<b><u>Capital ratios for Bancorp:</u></b>						
As of June 30, 2016						
Total capital (to Risk- Weighted Assets)	\$84,710	11.8 %	\$62,173	≥8.625%	N/A	N/A
Tier I capital (to Risk- Weighted Assets)	\$76,773	10.7 %	\$47,756	≥6.625%	N/A	N/A
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$76,773	10.7 %	\$36,944	≥5.515%	N/A	N/A
Tier I capital (to Average Assets)	\$76,773	8.5 %	\$36,048	≥4.0%	N/A	N/A
As of December 31, 2015						
Total capital (to Risk- Weighted Assets)	\$81,852	12.3 %	\$53,353	≥8.0%	N/A	N/A
Tier I capital (to Risk- Weighted Assets)	\$74,258	11.1 %	\$40,014	≥6.0%	N/A	N/A
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$74,258	11.1 %	\$30,011	≥4.5%	N/A	N/A
Tier I capital (to Average Assets)	\$74,258	9.2 %	\$32,478	≥4.0%	N/A	N/A

Our bank subsidiary is also subject to capital requirements similar to those discussed above. The bank subsidiary’s capital ratios do not vary materially from our capital ratios presented above. At June 30, 2016, our bank subsidiary exceeded the minimum ratios established by the FRB.

## Liquidity Management

Since the Company is a holding company and does not conduct regular banking operations, its primary sources of liquidity are dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to the Company is restricted to the lesser of the Bank's retained earnings or the amount of the Bank's undistributed net profits from the previous three fiscal years. The primary uses of funds for the Company are stockholder dividends, investment in the Bank and ordinary operating expenses. Management anticipates that there will be sufficient earnings at the Bank level to provide dividends to the Company to meet its funding requirements for the foreseeable future.

Maintenance of adequate liquidity requires that sufficient resources be available at all times to meet our cash flow requirements. Liquidity in a banking institution is required primarily to provide for deposit withdrawals and the credit needs of its customers and to take advantage of investment opportunities as they arise. Liquidity management involves our ability to convert assets into cash or cash equivalents without incurring significant loss, and to raise cash or maintain funds without incurring excessive additional cost. For this purpose, we maintain a portion of our funds in cash and cash equivalents, salable government guaranteed loans and securities available for sale. We obtain funds from the repayment and maturity of loans as well as deposit inflows, investment security maturities and paydowns, Federal funds purchased, FHLB advances, and other borrowings. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturity of certificate of deposits, repayment of borrowings and dividends to common and preferred stockholders. Our liquid assets at June 30, 2016 were \$236.1 million compared to \$269.3 million at December 31, 2015. Our liquidity level measured as the percentage of liquid assets to total assets was 25.5% and 30.0% at June 30, 2016 and December 31, 2015, respectively. We anticipate that cash and cash equivalents on hand and other sources of funds will provide adequate liquidity for our operating, investing and financing needs and our regulatory liquidity requirements for the foreseeable future. Management monitors our liquidity position daily, balancing loan funding/payments with changes in deposit activity and overnight investments.

As a secondary source of liquidity, we rely on advances from the FHLB to supplement our supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB are typically secured by a portion of our loan portfolio. The FHLB determines limitations on the amount of advances by assigning a percentage to each eligible loan category that will count towards the borrowing capacity. As of June 30, 2016, our borrowing capacity from the FHLB was approximately \$226.4 million and there were no outstanding advances. We also maintain 3 lines of credit with correspondent banks to purchase up to \$48 million in federal funds, for which there were no advances as of June 30, 2016.

### **Off-Balance-Sheet Arrangements**

During the ordinary course of business, we provide various forms of credit lines to meet the financing needs of our customers. These commitments, which represent a credit risk to us, are not represented in any form on our balance sheets.

As of June 30, 2016 and December 31, 2015, we had commitments to extend credit of \$99.4 million and \$91.7 million, respectively, which includes obligations under letters of credit of \$1.8 million and \$1.6 million, respectively.

The effect on our revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will be used.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not applicable.

### **Item 4. Controls and Procedures**

The Company's Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures, as defined in Exchange Act Rules 13 a-15(e) and 15(d)-15(e) promulgated under the Exchange Act, as of the end of the period covered by this report (the "Evaluation Date") have concluded that as of the Evaluation Date, the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company would be made known to them by others within the Company, particularly during the period in which this report was being prepared. Disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There were no significant changes in our internal control over financial reporting during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting subsequent to the Evaluation Date, nor were there any significant deficiencies or material weaknesses in such controls requiring corrective actions.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

There are no pending, or to management's knowledge, any threatened, material legal proceedings to which we are a defendant, or to which any of our properties are subject. There are no material legal proceedings to which any director, any nominee for election as a director, any executive officer, or any associate of any such director, nominee or officer is a party adverse to us.

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

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

None.

### **Item 5. Other Information**

None.

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**Item 6.**

**Exhibits**

The following exhibits are filed as part of this report or hereby incorporated by reference to filings previously made with the SEC:

<b>Exhibit No.</b>	<b>Exhibit Description</b>
31.01	Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.02	Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.01	Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

\*In accordance with Rule 406T of Regulation S-T, the information in these exhibits is “furnished” and shall not be deemed to be “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.



**SIGNATURES**

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

**Oak Valley Bancorp**

Date: August 9, 2016 By: /s/ JEFFREY A. GALL

**Jeffrey A. Gall**

**Senior Vice President and Chief Financial Officer**

**(Principal Financial Officer and duly authorized**

**signatory)**

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