SIERRA BANCORP
Form 10-Q
August 07, 2017

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, 2017

Commission file number: 000-33063

Sierra Bancorp

(Exact name of Registrant as specified in its charter)

California	33-0937517
(State of Incorporation)	(IRS Employer Identification No)

86 North Main Street, Porterville, California	93257
(Address of principal executive offices)	(Zip Code)

(559) 782-4900

(Registrant's telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter 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 þ 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 þ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer þ
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨
	Emerging Growth Company ¨

If an emerging growth company, indicate by check mark if the Registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 17(a)(2)(B) of the Securities Act. ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No þ

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common stock, no par value, 13,838,149 shares outstanding as of August 1, 2017

FORM 10-Q

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PART I - FINANCIAL INFORMATION

Item 1 – Financial Statements

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, unaudited)

	June 30, 2017 (unaudited)	December 31, 2016 (audited)
ASSETS		
Cash and due from banks	$ 64,445	$ 79,087
Interest-bearing deposits in banks	12,730	41,355
Total cash & cash equivalents	77,175	120,442
Securities available-for-sale	579,581	530,083
Loans and leases:		
Gross loans and leases	1,299,239	1,262,531
Allowance for loan and lease losses	(9,230)	(9,701)
Deferred loan and lease fees, net	2,768	2,924
Net loans and leases	1,292,777	1,255,754
Foreclosed assets	2,141	2,225
Premises and equipment, net	28,438	28,893
Goodwill	8,268	8,268
Other intangible assets, net	2,589	2,803
Company owned life insurance	44,815	43,706
Other assets	42,196	40,699
	$ 2,077,980	$ 2,032,873
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$ 557,617	$ 524,552
Interest-bearing	1,234,240	1,170,919
Total deposits	1,791,857	1,695,471
Repurchase agreements	11,296	8,094
Short-term borrowings	-	65,000
Subordinated debentures, net	34,499	34,410
Other liabilities	24,205	24,020
Total Liabilities	1,861,857	1,826,995
Commitments and contingent liabilities (Note 8)		

Shareholders’ equity		
Common stock, no par value; 24,000,000 shares authorized; 13,832,549 and 13,776,589 shares issued and outstanding at June 30, 2017 and December 31, 2016, respectively	73,553	72,626
Additional paid-in capital	2,954	2,832
Retained earnings	138,066	132,180
Accumulated other comprehensive income (loss)	1,550	(1,760)
Total shareholders’ equity	216,123	205,878
	$ 2,077,980	$ 2,032,873

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF INCOME

(dollars in thousands, except per share data, unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Interest and dividend income				
Loans and leases, including fees	$ 15,837	$ 13,147	$ 30,806	$ 26,240
Taxable securities	2,141	2,052	4,149	4,199
Tax-exempt securities	932	730	1,737	1,460
Dividend income on securities	6	-	11	36
Federal funds sold and other	139	5	255	32
Total interest income	19,055	15,934	36,958	31,967
Interest expense				
Deposits	868	508	1,557	999
Short-term borrowings	10	31	21	56
Subordinated debentures	337	200	657	402
Total interest expense	1,215	739	2,235	1,457
Net interest income	17,840	15,195	34,723	30,510
Provision for loan losses	300	-	300	-
Net interest income after provision for loan losses	17,540	15,195	34,423	30,510
Non-interest income				
Service charges on deposits	2,776	2,478	5,348	4,848
Net gains on sale of securities available-for-sale	58	146	66	122
Other income	2,530	1,950	5,084	3,898
Total non-interest income	5,364	4,574	10,498	8,868
Other operating expense				
Salaries and employee benefits	7,253	6,624	15,138	13,490
Occupancy and equipment	2,235	1,866	4,555	3,617
Other	5,603	5,225	11,099	10,087
Total non-interest expenses	15,091	13,715	30,792	27,194
Income before taxes	7,813	6,054	14,129	12,184
Provision for income taxes	2,611	1,968	4,375	4,062
Net income	$ 5,202	$ 4,086	$ 9,754	$ 8,122
PER SHARE DATA				
Book value	$ 15.62	$ 14.93	$ 15.62	$ 14.93
Cash dividends	$ 0.14	$ 0.12	$ 0.28	$ 0.24
Earnings per share basic	$ 0.38	$ 0.31	$ 0.71	$ 0.61
Earnings per share diluted	$ 0.37	$ 0.31	$ 0.70	$ 0.61
Average shares outstanding, basic	13,831,345	13,280,433	13,816,576	13,272,903
Average shares outstanding, diluted	14,010,328	13,393,448	14,009,485	13,388,664

Total shareholder equity (in thousands)	$ 216,123	$ 198,315	$ 216,123	$ 198,315
Shares outstanding	13,832,549	13,285,568	13,832,549	13,285,568
Dividends paid (in thousands)	$ 1,936	$ 1,593	$ 3,867	$ 3,185

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in thousands, unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Net Income	$ 5,202	$ 4,086	$ 9,754	$ 8,122
Other comprehensive income, before tax:				
Unrealized gains on securities:				
Unrealized holding gains arising during period	4,368	2,486	5,778	4,487
Less: reclassification adjustment for gains included in net income[1]	(58)	(146)	(66)	(122)
Other comprehensive income, before tax	4,310	2,340	5,712	4,365
Income tax expense related to items of other comprehensive income, net of tax	(1,812)	(984)	(2,402)	(1,814)
Other comprehensive income gain	2,498	1,356	3,310	2,551
Comprehensive Income	$ 7,700	$ 5,442	$ 13,064	$ 10,673

[1] Amounts are included in net gains on investment securities available-for-sale on the Consolidated Statements of Income in non-interest revenue. Income tax expense associated with the reclassification adjustment for the three months ended June 30, 2017 and 2016 was $24 thousand and $61 thousand respectively. Income tax expense associated with the reclassification adjustment for the six months ended June 30, 2017 and 2016 was $28 thousand and $51 thousand respectively.

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Six months ended June 30,	
	2017	2016
Cash flows from operating activities:		
Net income	$ 9,754	$ 8,122
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of securities	(66)	(122)
Loss on disposal of fixed assets	2	2
(Gain) loss on sale on foreclosed assets	(12)	1
Writedowns on foreclosed assets	75	262
Share-based compensation expense	441	169
Provision for loan losses	300	-
Depreciation and amortization	1,462	1,209
Net amortization on securities premiums and discounts	3,433	3,312
(Accretion) amortization of discounts/premiums for loans acquired and deferred loan fees/costs	(80)	164
(Increase) decrease in cash surrender value of life insurance policies	(1,109)	311
Amortization of core deposit intangible	213	78
Increase in interest receivable and other assets	(3,907)	(11)
Decrease (increase) in other liabilities	185	(3,959)
Deferred income tax provision	133	310
Net cash provided by operating activities	10,824	9,848
Cash flows from investing activities:		
Maturities of securities available for sale	-	30
Proceeds from sales/calls of securities available for sale	17,625	5,365
Purchases of securities available for sale	(114,633)	(70,675)
Principal pay downs on securities available for sale	49,856	45,536
Purchases of FHLB stock	(235)	(399)
Net increase in loans receivable, net	(37,321)	(24,129)
Purchases of premises and equipment, net	(920)	(1,901)
Proceeds from sale premises and equipment	-	231
Proceeds from sales of foreclosed assets	99	729
Net cash used in investing activities	(85,529)	(45,213)
Cash flows from financing activities:		
Increase in deposits	96,386	21,446
(Decrease) increase in borrowed funds	(65,000)	16,400
Increase in fed funds purchased	-	4,100
Increase in repurchase agreements	3,202	789

Cash dividends paid	(3,867)	(3,185)
Stock options exercised	717	233
Net cash provided by financing activities	31,438	39,783
(Decrease) increase in cash and due from banks	(43,267)	4,418
Cash and cash equivalents		
Beginning of period	120,442	48,623
End of period	$ 77,175	$ 53,041

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

Sierra Bancorp

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2017

(Unaudited)

Note 1 – The Business of Sierra Bancorp

Sierra Bancorp (the “Company”) is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the “Bank”), and has been the Bank’s sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. As of June 30, 2017, the Company’s only other subsidiaries were Sierra Statutory Trust II, Sierra Capital Trust III, and Coast Bancorp Statutory Trust II, which exist solely to facilitate the issuance of capital trust pass-through securities (“TRUPS”). Pursuant to the Financial Accounting Standards Board (“FASB”) standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the Company’s financial statements. References herein to the “Company” include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

Bank of the Sierra, a California state-chartered bank headquartered in Porterville, California, offers a full range of retail and commercial banking services in California’s South San Joaquin Valley, the Central Coast, Ventura County, and neighboring communities. The Bank was incorporated in September 1977, and opened for business in January 1978 as a one-branch bank with $1.5 million in capital. Our growth in the ensuing years has largely been organic in nature, but includes three whole-bank acquisitions: Sierra National Bank in 2000, Santa Clara Valley Bank in 2014, and Coast National Bank in July of 2016. The Bank now operates 34 full-service branches, a loan production office, and an online branch, and maintains ATMs at all branch locations and seven non-branch locations. Our most recent branching activity occurred in the first quarter of 2017, with a de novo branch opened on California Avenue in Bakersfield and our Paso Robles branch relocated to a superior site in reasonably close proximity to the previous location. The Company plans to expand even further in the fourth quarter of 2017 with the acquisition of OCB Bancorp, the holding company for Ojai Community Bank, and the purchase of the Woodlake branch of Citizens Business Bank (see Note 13 to the financial statements, Recent Developments, for more details on the proposed acquisitions). We have also received regulatory approvals for a de novo branch in Pismo Beach, California, although the timing for that branch opening remains uncertain, and have plans to relocate our Fresno Herndon branch to a nearby location with easier access and better visibility. In addition to our stand-alone offices the Bank has specialized lending units which include a real estate industries center, an agricultural credit center, and an SBA lending unit. We were close to $2.1 billion in total assets as of June 30, 2017, and for the past several years have claimed the distinction of being the largest bank headquartered in the South San Joaquin Valley. The Bank’s deposit accounts, which totaled almost $1.8 billion at June 30, 2017, are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to maximum insurable amounts.

Note 2 – Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles ("GAAP") for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of Management, necessary for a fair statement of the results for such periods. Such adjustments can generally be considered as normal and recurring unless otherwise disclosed in this Form 10-Q. In preparing the accompanying financial statements, Management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2016 have been reclassified to be consistent with the reporting for 2017. The interim financial information should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the Securities and Exchange Commission (the "SEC").

Note 3 – Current Accounting Developments

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU is the result of a joint project initiated by the FASB and the International Accounting Standards Board (IASB) to clarify the principles for recognizing revenue, and to develop common revenue standards and disclosure requirements that would: (1) remove inconsistencies and weaknesses in revenue requirements; (2) provide a more robust framework for addressing revenue issues; (3) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; (4) provide more useful information to users of financial statements through improved disclosures; and (5) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required with regard to contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. This ASU is effective for annual reporting periods beginning after December 15, 2017, including interim periods therein, with early adoption permitted for reporting periods beginning after December 15, 2016. The Company plans to adopt ASU 2014-09 on January 1, 2018 utilizing the modified retrospective approach. Since the guidance does not apply to revenue associated with financial instruments such as loans and investments, which are accounted for under other provisions of GAAP, we do not expect it to impact interest income, our largest component of income. The Company is currently performing an overall assessment of revenue streams potentially affected by the ASU, including certain deposit related fees and interchange fees, to determine the potential impact of this guidance on our consolidated financial statements.

In January 2016 the FASB issued ASU 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*. This guidance primarily affects the accounting for equity securities with readily determinable fair values, by requiring that the changes in fair value for such securities will be reflected in earnings rather than in other comprehensive income. The accounting for other financial instruments such as loans, debt securities, and financial liabilities is largely unchanged. ASU 2016-01 also changes the presentation and disclosure requirements for financial instruments, including a requirement that public business entities use exit pricing when estimating fair values for financial instruments measured at amortized cost for disclosure purposes. ASU 2016-01 is generally effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Based on Management's evaluation of the provisions of ASU 2016-01, we have determined that the difference between the amortized cost and fair market value of our equity securities, which constitutes a $993,000 gain at June 30, 2017, would be credited to retained earnings, net of tax as a one-time cumulative-effect adjustment upon our adoption of this ASU on January 1, 2018, with any subsequent changes in fair market value reflected in our income statement. There would likely be no other impact on our consolidated financial statements or disclosures. We are exploring the possibility of selling most of our equity securities during the current fiscal year, in which case there would be no impact on our consolidated financial statements upon adoption of ASU 2016-01.

In February 2016 the FASB issued ASU 2016-02, *Leases (Topic 842)*. The intention of this standard is to increase the transparency and comparability around lease obligations. Previously unrecorded off-balance sheet obligations will now be brought more prominently to light by presenting lease liabilities on the face of the balance sheet, accompanied by enhanced qualitative and quantitative disclosures in the notes to the financial statements. ASU 2016-02 is generally effective for public business entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company has leases on 17 branch locations, a loan production office, and an administrative office, which are considered operating leases and are not currently reflected in our financial statements. We expect that these lease agreements will be recognized on our consolidated statements of condition as right-of-use assets and corresponding lease liabilities subsequent to implementing ASU 2016-02, but we are still evaluating the extent to which this will impact our consolidated financial statements.

In March 2016 the FASB issued ASU 2016-09, *Compensation–Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*, as part of its simplification initiative. ASU 2016-09 became effective for public business entities for annual reporting periods beginning after December 15, 2016, and interim periods within that reporting period. The Company adopted ASU 2016-09 effective January 1, 2017. Prior guidance dictated that as they relate to share-based payments, tax benefits in excess of compensation costs (“windfalls”) were to be recorded in equity, and tax deficiencies (“shortfalls”) were to be recorded in equity to the extent of previous windfalls and then to the income statement. ASU 2016-09 reduced some of the administrative complexities by eliminating the need to track a windfall “pool,” but as we have already experienced, it also increases the volatility of income tax expense. ASU 2016-09 also removed the requirement to delay recognition of a windfall tax benefit until such time as it reduces current taxes payable. Under the new guidance, the benefit is recorded when it arises, subject to normal valuation allowance considerations. This change was applied by us on a modified retrospective basis, as required, with a cumulative-effect adjustment to opening retained earnings. Furthermore, all tax-related cash flows resulting from share-based payments are now reported as operating activities on the statement of cash flows, a change from the previous requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. However, cash paid by an employer when directly withholding shares for tax withholding purposes is classified as a financing activity. Under the new guidance, entities were permitted to make an accounting policy election for the impact of forfeitures on expense recognition for share-based payment awards. Forfeitures can be estimated in advance, as required previously, or recognized as they occur. Estimates are still required in certain circumstances, such as at the time of modification of an award or issuance of a replacement award in a business combination. If elected, the change to recognize forfeitures when they occur would have been adopted using a modified retrospective approach, with a cumulative effect adjustment recorded to opening retained earnings. We did not elect to recognize forfeitures as they occur, and continue to estimate potential forfeitures in advance.

In June 2016 the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which eliminates the probable initial recognition threshold for credit losses in current U.S. GAAP, and instead requires an organization to record a current estimate of all expected credit losses over the contractual term for financial assets carried at amortized cost. This is commonly referred to as the current expected credit losses ("CECL") methodology. Expected credit losses for financial assets held at the reporting date will be measured based on historical experience, current conditions, and reasonable and supportable forecasts. Another change from existing U.S. GAAP involves the treatment of purchased credit deteriorated assets, which are more broadly defined than purchased credit impaired assets in current accounting standards. When such assets are purchased, institutions will estimate and record an allowance for credit losses that is added to the purchase price rather than being reported as a credit loss expense. Furthermore, ASU 2016-13 updates the measurement of credit losses on available-for-sale debt securities, by mandating that institutions record credit losses on available-for-sale debt securities through an allowance for credit losses rather than the current practice of writing down securities for other-than-temporary impairment. ASU 2016-13 will also require the enhancement of financial statement disclosures regarding estimates used in calculating credit losses. ASU 2016-13 does not change the existing write-off principle in U.S. GAAP or current nonaccrual practices, nor does it change accounting requirements for loans held for sale or certain other financial assets which are measured at the lower of amortized cost or fair value. As a public business entity that is an SEC filer, ASU 2016-13 becomes effective for the Company on January 1, 2020, although early application is permitted for 2019. On the effective date, institutions will apply the new accounting standard as follows: for financial assets carried at amortized cost, a cumulative-effect adjustment will be recognized on the balance sheet for any change in the related allowance for loan and lease losses generated by the adoption of the new standard; financial assets classified as purchased credit impaired assets prior to the effective date will be reclassified as purchased credit deteriorated assets as of the effective date, and will be grossed up for the related allowance for expected credit losses created as of the effective date; and, debt securities on which other-than-temporary impairment had been recognized prior to the effective date will transition to the new guidance prospectively with no change in their amortized cost basis. The Company has commenced its transition efforts by establishing an implementation team, comprised of the Company's executive officers and certain other members of our credit administration and finance departments and chaired by our Chief Credit Officer. The Company's preliminary evaluation indicates that the provisions of ASU 2016-13 will impact our consolidated financial statements, in particular the level of our reserve for credit losses and shareholders' equity. However, we continue to evaluate the potential extent of that impact.

In January 2017 the FASB issued ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*. Currently, Topic 805 specifies three elements of a business – inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs, for example, by integrating the acquired set with their own inputs and processes. This led many transactions to be accounted for as business combinations rather than asset purchases under legacy GAAP. The primary goal of ASU 2017-01 is to narrow the definition of a business, and the guidance in this update provides a screen to determine when a set is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. This screen reduces the number of transactions that need to be further evaluated. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The amendments in this update should be applied prospectively on or after the effective date. The Company is currently evaluating this ASU to determine the impact on its consolidated financial position, results of operations and cash flows.

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In January 2017 the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment*. This guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation, and goodwill impairment will simply be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. All other goodwill impairment guidance will remain largely unchanged. Entities will continue to have the option to perform a qualitative assessment to determine if a quantitative impairment test is necessary. The same one-step impairment test will be applied to goodwill at all reporting units, even those with zero or negative carrying amounts. Entities will be required to disclose the amount of goodwill at reporting units with zero or negative carrying amounts. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2019. We have not been required to record any goodwill impairment to date, and after a preliminary review do not expect that this guidance would require us to do so given current circumstances. Nevertheless, we will continue to evaluate ASU 2017-04 to more definitely determine its potential impact on the Company's consolidated financial position, results of operations and cash flows.

In March 2017 the FASB issued ASU 2017-08, *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The amendments in this update shorten the amortization period for certain callable debt securities held at a premium, by requiring the premium to be amortized to the earliest call date. Under current guidance, the premium on a callable debt security is generally amortized as an adjustment to yield over the contractual life of the instrument, and any unamortized premium is recorded as a loss in earnings upon the debtor's exercise of a call provision. Under ASU 2017-08, because the premium will be amortized to the earliest call date, entities will no longer recognize a loss in earnings if a debt security is called prior to the contractual maturity date. The amendments do not require an accounting change for securities held at a discount; discounts will continue to be amortized as an adjustment to yield over the contractual life of the debt instrument. ASU 2017-08 is effective for public business entities, including the Company, for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments must be reflected as of the beginning of the fiscal year that includes that interim period. To apply ASU 2017-08, entities must use a modified retrospective approach, with the cumulative-effect adjustment recognized to retained earnings at the beginning of the period of adoption. Entities are also required to provide disclosures about a change in accounting principle in the period of adoption. The Company has evaluated the potential impact of this guidance, and does not expect the adoption of ASU 2017-08 to have a material impact on our financial statements or operations.

In May 2017 the FASB issued ASU 2017-09, *Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting*. This update was issued to provide clarity, reduce diversity in practice, and lower cost and complexity when applying the guidance in Topic 718. Under the updated guidance, an entity will be expected to account for the effects of an equity award modification unless all the following are met: 1) the fair value of the modified award is the same as the fair value of the original award immediately before the original award is modified; 2) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; 3) the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. The current disclosure requirements in Topic 718 continue to apply. ASU 2017-09 is effective for public business entities, including the Company, for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period for public business entities for reporting periods for which financial statements have not yet been issued. Since the Company has not modified equity awards in the past and does not expect to do so in the future, we do not anticipate any impact on our financial statements or operations from the adoption of ASU 2017-09.

Note 4 – Supplemental Disclosure of Cash Flow Information

During the six months ended June 30, 2017 and 2016, cash paid for interest due on interest-bearing liabilities was $2.273 million and $1.423 million, respectively. There was $5.647 million in cash paid for income taxes during the six months ended June 30, 2017, and $2.500 million for the six months ended June 30, 2016. Assets totaling $115,000 and $694,000 were acquired in settlement of loans for the six months ended June 30, 2017 and June 30, 2016, respectively. We received $99,000 in cash from the sale of foreclosed assets during the first six months of 2017 relative to $729,000 during the first six months of 2016, which represents sales proceeds less loans (if any) extended to finance such sales.

Note 5 – Share Based Compensation

On March 16, 2017 the Company's Board of Directors approved and adopted the 2017 Stock Incentive Plan (the "2017 Plan"), which became effective May 24, 2017 pursuant to the approval of the Company's shareholders. The 2017 Plan replaced the Company's 2007 Stock Incentive Plan (the "2007 Plan"), which expired by its own terms on March 15, 2017. Options to purchase 500,120 shares that were granted under the 2007 Plan were still outstanding as of June 30, 2017, and remain unaffected by that plan's expiration. The 2017 Plan provides for the issuance of both "incentive" and "nonqualified" stock options to officers and employees, and of "nonqualified" stock options to non-employee directors and consultants of the Company. The 2017 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, although no restricted stock awards have ever been issued by the Company. The total number of shares of the Company's authorized but unissued stock reserved for issuance pursuant to awards under the 2017 Plan is 850,000 shares. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share.

Pursuant to FASB's standards on stock compensation, the value of each stock option granted is reflected in our income statement as employee compensation or directors' expense by expensing its fair value as of the grant date in the case of immediately vested options, or by amortizing its grant date fair value over the vesting period for options with graded vesting. The Company is utilizing the Black-Scholes model to value stock options, and the "multiple option" approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach an employee's options for each vesting period are separately valued and amortized, which appears to be the preferred method for option grants with graded vesting. A pre-tax charge of $18,000 was reflected in the Company's income statement during the second quarter of 2017 and $12,000 was charged during the second quarter of 2016, as expense related to stock options. For the first half, the charges totaled $441,000 in 2017 and $169,000 in 2016.

Note 6 – Earnings per Share

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 13,831,345 weighted average shares outstanding during the second quarter of 2017, and 13,280,433 during the second quarter of 2016. There were 13,816,576 weighted average shares outstanding during the first six months of 2017, and 13,272,903 during the first six months of 2016.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of "in-the-money" stock options. For the second quarter of 2017, calculations under the treasury stock method resulted in the equivalent of 178,983 shares being added to basic weighted average shares outstanding for purposes of determining diluted earnings per share, while a weighted average of 120,700 stock options were excluded from the calculation because they were underwater and thus anti-dilutive. For the second quarter of 2016 the equivalent of 113,015 shares were added in calculating diluted earnings per share, while 162,700 anti-dilutive stock options were not factored into the computation. Likewise, for the first half of 2017 the equivalent of 192,909 shares were added to basic weighted average shares outstanding in calculating diluted earnings per share and a weighted average of 120,700 stock options that were anti-dilutive for the period were not included, compared to the addition of the equivalent of 115,761 shares and non-inclusion of 212,700 anti-dilutive options in calculating diluted earnings per share for first half of 2016.

Note 7 – Comprehensive Income

As presented in the Consolidated Statements of Comprehensive Income, comprehensive income includes net income and other comprehensive income. The Company’s only source of other comprehensive income is unrealized gains and losses on available-for-sale investment securities. Gains or losses on investment securities that were realized and reflected in net income of the current period, which had previously been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose, are considered to be reclassification adjustments that are excluded from other comprehensive income in the current period.

Note 8 – Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business. Those financial instruments currently consist of unused commitments to extend credit and standby letters of credit. They involve, to varying degrees, elements of risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by counterparties for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and issuing letters of credit as it does for originating loans included on the balance sheet. The following financial instruments represent off-balance-sheet credit risk (dollars in thousands):

	June 30, 2017	December 31, 2016
Commitments to extend credit	$ 583,562	$ 463,923
Standby letters of credit	$ 8,432	$ 8,582

Commitments to extend credit consist primarily of the unused or unfunded portions of the following: home equity lines of credit; commercial real estate construction loans, where disbursements are made over the course of construction; commercial revolving lines of credit; mortgage warehouse lines of credit; unsecured personal lines of credit; and formalized (disclosed) deposit account overdraft lines. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many commitments are expected to expire without being drawn upon, the unused portions of committed amounts do not necessarily represent future cash requirements. Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party, and the credit risk involved in issuing letters of credit is essentially the same as the risk involved in extending loans to customers.

At June 30, 2017, the Company was also utilizing a letter of credit in the amount of $87 million issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits and to facilitate certain credit arrangements with the Company's customers. That letter of credit is backed by loans which are pledged to the FHLB by the Company.

Note 9 – Fair Value Disclosures and Reporting, the Fair Value Option and Fair Value Measurements

FASB's standards on financial instruments, and on fair value measurements and disclosures, require all entities to disclose in their financial statement footnotes the estimated fair values of financial instruments for which it is practicable to estimate such. In addition to disclosure requirements, FASB's standard on investments requires that our debt securities which are classified as available for sale and our equity securities that have readily determinable fair values be measured and reported at fair value in our statement of financial position. Certain impaired loans are also reported at fair value, as explained in greater detail below, and foreclosed assets are carried at the lower of cost or fair value. FASB's standard on financial instruments permits companies to report certain other financial assets and liabilities at fair value, but we have not elected the fair value option for any of those financial instruments.

Fair value measurement and disclosure standards also establish a framework for measuring fair values. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants on the measurement date. Further, the standards establish a fair value hierarchy that encourages an entity to maximize the use of observable inputs and limit the use of unobservable inputs when measuring fair values. The standards describe three levels of inputs that may be used to measure fair values:

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

- Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

- Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would likely consider in pricing an asset or liability.

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. The estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to realized gains and losses could have a significant effect on fair value estimates but have not been considered in those estimates. Because no active market exists for a significant portion of our financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. The estimates are subjective and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly alter the fair values presented. The following methods and assumptions were used by the Company to estimate its financial instrument fair values disclosed at June 30, 2017 and December 31, 2016:

- Cash and cash equivalents and fed funds sold: The carrying amount is estimated to be fair value.

- Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities when quoted prices for specific securities are not readily available.

- Loans and leases: For variable-rate loans and leases that re-price frequently with no significant changes in credit risk or interest rate spreads relative to current market pricing, fair values are based on carrying values. Fair values for other loans and leases are estimated by discounting projected cash flows at interest rates being offered at each reporting date for loans and leases with similar terms, to borrowers of comparable creditworthiness. The carrying amount of accrued interest receivable approximates its fair value.

- Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are not relevant for reporting purposes. If available-for-sale loans are on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.

- Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.

- Cash surrender value of life insurance policies: Fair values are based on net cash surrender values at each reporting date.

- Other investments: Certain investments for which no secondary market exists are carried at cost and the carrying amount for those investments typically approximates their estimated fair value, unless an impairment analysis indicates the need for adjustments.

- Deposits: Fair values for non-maturity deposits are equal to the amount payable on demand at the reporting date, which is the carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a cash flow analysis, discounted at interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

- Short-term borrowings: Current carrying amounts are used as an approximation of fair values for federal funds purchased, overnight advances from the Federal Home Loan Bank (“FHLB”), borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days of the reporting dates. Fair values of other short-term borrowings are estimated by discounting projected cash flows at the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

- Long-term borrowings: Fair values are estimated using projected cash flows discounted at the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

- Subordinated debentures: Fair values are determined based on the current market value for like instruments of a similar maturity and structure.

- Commitments to extend credit and letters of credit: If funded, the carrying amounts for currently unused commitments would provide an equivalent measure of fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not those commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.

Estimated fair values for the Company's financial instruments are as follows, as of the dates noted:

Fair Value of Financial Instruments

(dollars in thousands, unaudited)

	June 30, 2017				
		Estimated Fair Value			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets:					
Cash and cash equivalents	$77,175	$77,175	$-	$ -	$77,175
Investment securities available for sale	579,581	1,487	578,094	-	579,581
Loans and leases, net held for investment	1,292,777	-	1,304,509	-	1,304,509
Collateral dependent impaired loans	-	-	-	-	-
Cash surrender value of life insurance policies	44,815	-	44,815	-	44,815
Other investments	8,741	-	8,741	-	8,741
Accrued interest receivable	6,490	-	6,490	-	6,490
Financial liabilities:					
Deposits:					
Noninterest-bearing	$557,617	$557,617	$-	$ -	$557,617
Interest-bearing	1,234,240	-	1,234,690	-	1,234,690
Fed funds purchased and repurchase agreements	11,296	-	11,296	-	11,296
Short-term borrowings	-	-	-	-	-
Subordinated debentures	34,499	-	23,995	-	23,995
Accrued interest payable	150	-	150	-	150
	Notional Amount				
Off-balance-sheet financial instruments:					
Commitments to extend credit	$583,562				
Standby letters of credit	8,432				

December 31, 2016

	Carrying Amount	Estimated Fair Value Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets:					
Cash and cash equivalents	$120,442	$120,442	$-	$ -	$120,442
Investment securities available for sale	530,083	1,546	528,537	-	530,083
Loans and leases, net held for investment	1,255,348	-	1,266,447	-	1,266,447
Collateral dependent impaired loans	406	-	406	-	406
Cash surrender value of life insurance policies	43,706	-	43,706	-	43,706
Other investments	8,506	-	8,506	-	8,506
Accrued interest receivable	6,354	-	6,354	-	6,354
Financial liabilities:					
Deposits:					
Noninterest-bearing	$524,552	$524,552	$-	$ -	$524,552
Interest-bearing	1,170,919	-	1,171,188	-	1,171,188
Fed funds purchased and repurchase agreements	8,094	-	8,094	-	8,094
Short-term borrowings	65,000	-	65,000	-	65,000
Subordinated debentures	34,410	-	22,633	-	22,633
Accrued interest payable	188	-	188	-	188

	Notional Amount
Off-balance-sheet financial instruments:	
Commitments to extend credit	$463,923
Standby letters of credit	8,582

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For financial asset categories that were actually reported at fair value as of June 30, 2017 and December 31, 2016, the Company used the following methods and significant assumptions:

- Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities.

- Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.

- Foreclosed assets: Repossessed real estate (known as other real estate owned, or "OREO") and other foreclosed assets are carried at the lower of cost or fair value. Fair value is the appraised value less expected selling costs for OREO and some other assets such as mobile homes, and fair values for any other foreclosed assets are represented by estimated sales proceeds as determined using reasonably available sources. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Fair values for other foreclosed assets are adjusted as necessary, subsequent to a periodic re-evaluation of expected cash flows and the timing of resolution. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

Assets reported at fair value on a recurring basis are summarized below:

Fair Value Measurements - Recurring
(dollars in thousands, unaudited)

	Fair Value Measurements at June 30, 2017, using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss)
Securities:					
US Government agencies	$ -	$ 25,717	$ -	$ 25,717	$ -
Mortgage-backed securities	-	412,745	-	412,745	-
State and political subdivisions	-	139,632	-	139,632	-

Equity securities	1,487	-	-	1,487	-
Total available-for-sale securities	$ 1,487	$ 578,094	$ -	$ 579,581	$ -

	Fair Value Measurements at December 31, 2016, using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss)
Securities:					
US Government agencies	$ -	$ 26,468	$ -	$ 26,468	$ -
Mortgage-backed securities	-	387,876	-	387,876	-
State and political subdivisions	-	114,193	-	114,193	-
Equity securities	1,546	-	-	1,546	-
Total available-for-sale securities	$ 1,546	$ 528,537	$ -	$ 530,083	$ -

Assets reported at fair value on a nonrecurring basis are summarized below:

Fair Value Measurements - Nonrecurring
(dollars in thousands, unaudited)

	Fair Value Measurements at June 30, 2017, using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real Estate:				
1-4 family residential construction	$ -	$ -	$ -	$ -
Other construction/land	-	-	-	-
1-4 family - closed-end	-	13	-	13
Equity lines	-	17	-	17
Multi-family residential	-	-	-	-
Commercial real estate - owner occupied	-	210	-	210
Commercial real estate-non-owner occupied	-	-	-	-
Farmland	-	-	-	-
Total real estate	-	240	-	240
Agriculture	-	-	-	-
Commercial and industrial	-	-	-	-
Consumer loans	-	14	-	14
Total impaired loans	-	254	-	254
Foreclosed assets	$ -	$ 2,141	$ -	$ 2,141
Total assets measured on a norecurring basis	$ -	$ 2,395	$ -	$ 2,395

	Fair Value Measurements at December 31, 2016, using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total

Impaired loans				
Real Estate:				
1-4 family residential construction	$ -	$ -	$ -	$ -
Other construction/land	-	-	-	-
1-4 family - closed-end	-	-	-	-
Equity lines	-	-	-	-
Multi-family residential	-	-	-	-
Commercial real estate - owner occupied	-	281	-	281
Commercial real estate-non-owner occupied	-	67	-	67
Farmland	-	-	-	-
Total real estate	-	348	-	348
Agriculture	-	-	-	-
Commercial and industrial	-	-	-	-
Consumer loans	-	58	-	58
Total impaired loans	-	406	-	406
Foreclosed assets	$ -	$ 2,225	$ -	$ 2,225
Total assets measured on a norecurring basis	$ -	$ 2,631	$ -	$ 2,631

The table above includes collateral-dependent impaired loan balances for which a specific reserve has been established or on which a write-down has been taken. Information on the Company's total impaired loan balances and specific loss reserves associated with those balances is included in Note 11 below, and in Management's Discussion and Analysis of Financial Condition and Results of Operation in the "Nonperforming Assets" and "Allowance for Loan and Lease Losses" sections.

The unobservable inputs are based on Management's best estimates of appropriate discounts in arriving at fair market value. Adjusting any of those inputs could result in a significantly lower or higher fair value measurement. For example, an increase or decrease in actual loss rates would create a directionally opposite change in the fair value of unsecured impaired loans.

Note 10 – Investments

Investment Securities

Although the Company currently has the intent and the ability to hold the securities in its investment portfolio to maturity, the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management. Pursuant to FASB's guidance on accounting for debt and equity securities, available for sale securities are carried on the Company's financial statements at their estimated fair market values, with monthly tax-effected "mark-to-market" adjustments made vis-à-vis accumulated other comprehensive income in shareholders' equity.

The amortized cost and estimated fair value of investment securities available-for-sale are as follows:

Amortized Cost And Estimated Fair Value
(dollars in thousands, unaudited):

	June 30, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
US Government agencies	$25,793	$ 162	$ (238)	$ 25,717
Mortgage-backed securities	414,065	1,641	(2,961)	412,745
State and political subdivisions	136,554	3,372	(294)	139,632
Equity securities	494	993	-	1,487
Total securities	$576,906	$ 6,168	$ (3,493)	$ 579,581

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
US Government agencies	$26,926	$ 48	$ (506)	$ 26,468
Mortgage-backed securities	391,555	1,492	(5,171)	387,876
State and political subdivisons	114,140	1,519	(1,466)	114,193
Equity securities	500	1,046	-	1,546
Total securities	$533,121	$ 4,105	$ (7,143)	$ 530,083

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At June 30, 2017 and December 31, 2016, the Company had 296 securities and 431 securities, respectively, with gross unrealized losses. Management has evaluated those securities as of the respective dates, and does not believe that any of the unrealized losses are other than temporary. Gross unrealized losses on our investment securities as of the indicated dates are disclosed in the table below, categorized by investment type and by the duration of time that loss positions on individual securities have continuously existed (over or under twelve months).

Investment Portfolio - Unrealized Losses

(dollars in thousands, unaudited)	June 30, 2017			
	Less than twelve months		Twelve months or more	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
US Government agencies	$(193)	$11,451	$(45)	$1,454
Mortgage-backed securities	(2,086)	234,206	(875)	54,646
State and political subdivisions	(282)	17,465	(12)	696
Total	$(2,561)	$263,122	$(932)	$56,796

	December 31, 2016			
	Less than twelve months		Twelve months or more	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
US Government agencies	$(500)	$21,056	$(6)	$711
Mortgage-backed securities	(4,303)	271,276	(868)	43,570
State and political subdivisions	(1,466)	49,195	-	-
Total	$(6,269)	$341,527	$(874)	$44,281

The table below summarizes the Company’s gross realized gains and losses as well as gross proceeds from the sales of securities, for the periods indicated:

Investment Portfolio - Realized Gains/(Losses)
(dollars in thousands, unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
	$ 4,721	$ 2,790	$ 17,625	$ 5,395

Proceeds from sales, calls and maturities of securities available for sale				
Gross gains on sales, calls and maturities of securities available for sale	$ 63	$ 146	$ 106	$ 160
Gross losses on sales, calls and maturities of securities available for sale	(5)	-	(40)	(38)
Net gains on sale of securities available for sale	$ 58	$ 146	$ 66	$ 122

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The amortized cost and estimated fair value of investment securities available-for-sale at June 30, 2017 and December 31, 2016 are shown below, grouped by the remaining time to contractual maturity dates. The expected life of investment securities may not be consistent with contractual maturity dates, since the issuers of the securities might have the right to call or prepay obligations with or without penalties.

Estimated Fair Value of Contractual Maturities
(dollars in thousands, unaudited)

	June 30, 2017	
	Amortized Cost	Fair Value
Maturing within one year	$8,552	$8,600
Maturing after one year through five years	258,614	259,441
Maturing after five years through ten years	40,566	41,538
Maturing after ten years	74,654	75,778
Securities not due at a single maturity date:		
US Government agencies collateralized by mortgage obligations	194,026	192,737
Other securities	494	1,487
	$576,906	$579,581

	December 31, 2016	
	Amortized Cost	Fair Value
Maturing within one year	$8,488	$8,573
Maturing after one year through five years	260,387	259,535
Maturing after five years through ten years	50,823	50,687
Maturing after ten years	47,132	46,190
Securities not due at a single maturity date:		
US Government agencies collateralized by mortgage obligations	165,791	163,552
Other securities	500	1,546
	$533,121	$530,083

At June 30, 2017, the Company’s investment portfolio was comprised of 337 bonds issued by government municipalities and agencies located within 32 states, with an aggregate fair value of $139.6 million. The largest exposure to any single municipality or agency was a combined $2.585 million (fair value) in general obligation bonds issued by the Lindsay (CA) Unified School District.

The Company’s investments in bonds issued by states, municipalities and political subdivisions are evaluated in accordance with Supervision and Regulation Letter 12-15 issued by the Board of Governors of the Federal Reserve

System, “Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings,” and other regulatory guidance. Credit ratings are considered in our analysis only as a guide to the historical default rate associated with similarly-rated bonds. There have been no significant differences in our internal analyses compared with the ratings assigned by the third party credit rating agencies.

The following table summarizes the amortized cost and fair values of general obligation and revenue bonds in the Company’s investment securities portfolio at the indicated dates, identifying the state in which the issuing municipality or agency operates for our largest geographic concentrations:

Revenue and General Obligation Bonds by Location (dollars in thousands, unaudited)	June 30, 2017		December 31, 2016	
General obligation bonds	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
State of issuance				
Texas	$29,104	$ 29,570	$20,170	$ 19,875
California	28,399	29,354	25,457	25,799
Washington	12,524	12,803	5,928	5,970
Ohio	9,374	9,502	9,412	9,324
Illinois	8,398	8,589	9,873	9,871
Utah	948	981	949	957
Other (20 states)	24,310	24,845	21,688	21,741
Total General Obligation Bonds	113,057	115,644	93,477	93,537
Revenue bonds				
State of issuance				
Texas	6,718	6,825	5,727	5,702
Utah	5,413	5,510	5,286	5,236
Washington	2,112	2,184	1,302	1,299
California	1,029	1,044	1,283	1,298
Ohio	260	261	261	261
Other states (12 states)	7,965	8,164	6,804	6,860
Total Revenue Bonds	23,497	23,988	20,663	20,656
Total Obligations of States and Political Subdivisions	$136,554	$ 139,632	$114,140	$ 114,193

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The revenue bonds in the Company's investment securities portfolios were issued by government municipalities and agencies to fund public services such as utilities (water, sewer, and power), educational facilities, and general public and economic improvements. The primary sources of revenue for these bonds are delineated in the table below, which shows the amortized cost and fair market values for the largest revenue concentrations as of the indicated dates.

Revenue Bonds by Type				
(dollars in thousands, unaudited)	June 30, 2017		December 31, 2016	
	Amortized	Fair Market	Amortized	Fair Market
Revenue bonds	Cost	Value	Cost	Value
Revenue source:				
Water	$7,409	$ 7,483	$4,788	$ 4,722
Sales Tax	2,969	3,013	2,981	2,927
College & University	2,626	2,729	3,401	3,472
Lease	2,324	2,400	3,119	3,123
Local or GTD Housing	1,541	1,558	167	167
Other (15 sources)	6,628	6,805	9,326	9,368
Total Revenue Bonds	$23,497	$ 23,988	$20,663	$ 20,656

Low-Income Housing Tax Credit ("LIHTC") Fund Investments

The Company has the ability to invest in limited partnerships which own housing projects that qualify for federal and/or California state tax credits, by mandating a specified percentage of low-income tenants for each project. The tax credits flow through to investors, supplementing any returns that might be derived from an increase in property values. Because rent levels are lower than standard market rents and the projects are generally highly leveraged, each project also typically generates tax-deductible operating losses that are allocated to the limited partners.

The Company invested in nine different LIHTC fund limited partnerships from 2001 through 2017, all of which were California-focused funds that help the Company meet its obligations under the Community Reinvestment Act. We utilize the cost method of accounting for our LIHTC fund investments, under which we initially record on our balance sheet an asset that represents the total cash expected to be invested over the life of the partnership. Any commitments or contingent commitments for future investment are reflected as a liability. The income statement reflects tax credits and any other tax benefits from these investments "below the line" within our income tax provision, while the initial book value of the investment is amortized on a straight-line basis as an offset to non-interest income, over the time period in which the tax credits and tax benefits are expected to be received.

As of June 30, 2017 our total LIHTC investment book balance was $9.3 million, which includes $4.2 million in remaining commitments for additional capital contributions. There were $343,000 in tax credits derived from our

LIHTC investments that were recognized during the six months ended June 30, 2017, and amortization expense of $475,000 associated with those investments was included in pre-tax income for the same time period. Our LIHTC investments are evaluated annually for potential impairment, and we have concluded that the carrying value of the investments is stated fairly and is not impaired.

Note 11 – Credit Quality and Nonperforming Assets

Credit Quality Classifications

The Company monitors the credit quality of loans on a continuous basis using the regulatory and accounting classifications of pass, special mention, substandard and impaired to characterize the associated credit risk. Balances classified as "loss" are immediately charged off. The Company conforms to the following definitions for its risk classifications:

- Pass: Larger non-homogeneous loans not meeting the risk rating definitions below, and smaller homogeneous loans that are not assessed on an individual basis.

- Special mention: Loans which have potential issues that deserve the close attention of Management. If left uncorrected, those potential weaknesses could eventually diminish the prospects for full repayment of principal and interest according to the contractual terms of the loan agreement, or could result in deterioration of the Company's credit position at some future date.

- Substandard: Loans that have at least one clear and well-defined weakness that could jeopardize the ultimate recoverability of all principal and interest, such as a borrower displaying a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or a deteriorated financial condition.

- Impaired: A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include all nonperforming loans and restructured troubled debt ("TDRs"). A TDR may be nonperforming or performing, depending on its accrual status and the demonstrated ability of the borrower to comply with restructured terms (see "Troubled Debt Restructurings" section below for additional information on TDRs).

Credit quality classifications for the Company's loan balances were as follows, as of the dates indicated:

Credit Quality Classifications
(dollars in thousands, unaudited)

	June 30, 2017				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$44,248	$-	$ -	$-	$44,248
Other construction/land	46,401	328	56	580	47,365
1-4 family - closed end	143,814	605	324	5,449	150,192
Equity lines	33,169	3,370	488	4,680	41,707
Multi-family residential	30,501	-	-	562	31,063
Commercial real estate - owner occupied	248,053	4,508	2,812	2,012	257,385
Commercial real estate - non-owner occupied	270,076	4,531	3,176	1,688	279,471
Farmland	134,717	1,003	897	310	136,927
Total real estate	950,979	14,345	7,753	15,281	988,358
Agricultural	53,277	759	400	-	54,436
Commercial and industrial	104,571	10,951	708	2,668	118,898
Mortgage Warehouse	126,633	-	-	-	126,633
Consumer loans	9,280	225	21	1,388	10,914
Total gross loans and leases	$1,244,740	$26,280	$ 8,882	$19,337	$1,299,239

	December 31, 2016				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$32,417	$-	$ -	$-	$32,417
Other construction/land	38,699	888	-	1,063	40,650
1-4 family - closed end	129,726	624	403	6,390	137,143
Equity lines	35,159	3,165	698	4,421	43,443
Multi-family residential	31,058	-	-	573	31,631
Commercial real estate - owner occupied	243,366	4,991	2,892	2,286	253,535
Commercial real estate - non-owner occupied	233,584	5,597	3,220	1,797	244,198
Farmland	132,613	1,020	808	39	134,480
Total real estate	876,622	16,285	8,021	16,569	917,497
Agricultural	45,249	891	-	89	46,229
Commercial and industrial	107,404	13,186	732	2,273	123,595
Mortgage Warehouse	163,045	-	-	-	163,045
Consumer loans	10,303	191	9	1,662	12,165
Total gross loans and leases	$1,202,623	$30,553	$ 8,762	$20,593	$1,262,531

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Past Due and Nonperforming Assets

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets, including mobile homes and OREO. OREO consists of real properties acquired by foreclosure or similar means, which the Company is offering or will offer for sale. Nonperforming loans and leases result when reasonable doubt surfaces with regard to the ability of the Company to collect all principal and interest. At that point, we stop accruing interest on the loan or lease in question and reverse any previously-recognized interest to the extent that it is uncollected or associated with interest-reserve loans. Any asset for which principal or interest has been in default for 90 days or more is also placed on non-accrual status even if interest is still being received, unless the asset is both well secured and in the process of collection. An aging of the Company's loan balances is presented in the following tables, by number of days past due as of the indicated dates:

Loan Portfolio Aging
(dollars in thousands, unaudited)

	June 30, 2017						
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due[1]	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans[2]
Real Estate:							
1-4 family residential construction	$-	$ -	$ -	$ -	$44,248	$ 44,248	$ -
Other construction/land	56	-	-	56	47,309	47,365	140
1-4 family - closed end	-	13	540	553	149,639	150,192	869
Equity lines	625	-	69	694	41,013	41,707	1,715
Multi-family residential	-	-	-	-	31,063	31,063	-
Commercial real estate - owner occupied	944	-	233	1,177	256,208	257,385	1,310
Commercial real estate - non-owner occupied	-	-	-	-	279,471	279,471	-
Farmland	-	-	-	-	136,927	136,927	310
Total real estate	1,625	13	842	2,480	985,878	988,358	4,344
Agricultural	-	-	-	-	54,436	54,436	-
Commercial and industrial	13	-	686	699	118,199	118,898	988
Mortgage warehouse lines	-	-	-	-	126,633	126,633	-
Consumer	90	-	-	90	10,824	10,914	320
Total gross loans and leases	$1,728	$ 13	$ 1,528	$ 3,269	$1,295,970	$ 1,299,239	$ 5,652

[1] As of June 30, 2017 there were no loans over 90 days past due and still accruing.

[2] Included in total financing receivables

	December 31, 2016						
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due[1]	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans[2]
Real Estate:							
1-4 family residential construction	$-	$ -	$ -	$ -	$32,417	$ 32,417	$ -
Other construction/land	-	-	-	-	40,650	40,650	558
1-4 family - closed end	99	23	575	697	136,446	137,143	963
Equity lines	397	-	320	717	42,726	43,443	1,926
Multi-family residential	-	-	-	-	31,631	31,631	-
Commercial real estate - owner occupied	338	-	28	366	253,169	253,535	1,572
Commercial real estate - non-owner occupied	-	-	-	-	244,198	244,198	67
Farmland	-	-	-	-	134,480	134,480	39
Total real estate	834	23	923	1,780	915,717	917,497	5,125
Agricultural	-	-	89	89	46,140	46,229	89
Commercial and industrial	168	3	292	463	123,132	123,595	692
Mortgage warehouse lines	-	-	-	-	163,045	163,045	-
Consumer	94	9	52	155	12,010	12,165	459
Total gross loans and leases	$1,096	$ 35	$ 1,356	$ 2,487	$1,260,044	$ 1,262,531	$ 6,365

(1) As of December 31, 2016 there were no loans over 90 days past due and still accruing.

(2) Included in total financing receivables

Troubled Debt Restructurings

A loan that is modified for a borrower who is experiencing financial difficulty is classified as a troubled debt restructuring if the modification constitutes a concession. At June 30, 2017, the Company had a total of $16.1 million in TDRs, including $2.4 million in TDRs that were on non-accrual status. Generally, a non-accrual loan that has been modified as a TDR remains on non-accrual status for a period of at least six months to demonstrate the borrower’s ability to comply with the modified terms. However, performance prior to the modification, or significant events that coincide with the modification, could result in a loan’s return to accrual status after a shorter performance period or even at the time of loan modification. Regardless of the period of time that has elapsed, if the borrower’s ability to meet the revised payment schedule is uncertain then the loan will be kept on non-accrual status. Moreover, a TDR is generally considered to be in default when it appears that the customer will not likely be able to repay all principal and interest pursuant to restructured terms.

The Company may agree to different types of concessions when modifying a loan or lease. The tables below summarize TDRs which were modified during the noted periods, by type of concession:

Troubled Debt Restructurings, by Type of Loan Modification
(dollars in thousands, unaudited)

	Three months ended June 30, 2017			
	Term Modification	Interest Only Modification	Rate & Term Modification	Total
Real estate:				
Other construction/land	$ -	$ -	$ -	$ -
1-4 family - closed-end	-	-	43	43
Equity lines	322	-	-	322
Multi-family residential	-	-	-	-
Commercial real estate - owner occupied	-	-	-	-
Total real estate loans	322	-	43	365
Commercial and industrial	15	-	-	15
Consumer loans	-	-	-	-
	$ 337	$ -	$ 43	$ 380

	Three months ended June 30, 2016			
	Term Modification	Interest Only Modification	Rate & Term Modification	Total
Real Estate:				
Other construction/land	$ -	$ -	$ -	$ -

1-4 family - closed-end	-	547	259	806
Equity lines	1,051	-	-	1,051
Multi-family residential	-	-	132	132
Commercial real estate - owner occupied	-	-	-	-
Total real estate loans	1,051	547	391	1,989
Commercial and industrial	-	-	-	-
Consumer loans	-	-	10	10
	$ 1,051	$ 547	$ 401	$ 1,999

Troubled Debt Restructurings, by Type of Loan Modification
(dollars in thousands, unaudited)

	Six months ended June 30, 2017			
	Term Modification	Interest Only Modification	Rate & Term Modification	Total
Real estate:				
Other construction/land	$ -	$ -	$ -	$ -
1-4 family - closed-end	-	-	90	90
Equity lines	603	-	-	603
Multi-family residential	-	-	-	-
Commercial real estate - owner occupied	-	-	-	-
Total real estate loans	603	-	90	693
Commercial and industrial	15	-	-	15
Consumer loans	-	-	-	-
	$ 618	$ -	$ 90	$ 708

	Six months ended June 30, 2016			
	Term Modification	Interest Only Modification	Rate & Term Modification	Total
Real Estate:				
Other construction/land	$ 17	$ -	$ -	$ 17
1-4 family - closed-end	-	547	259	806
Equity lines	1,280	-	-	1,280
Multi-family residential	-	-	132	132
Commercial real estate - owner occupied	-	-	266	266
Total real estate loans	1,297	547	657	2,501
Commercial and industrial	-	-	-	-
Consumer loans	20	-	60	80
	$ 1,317	$ 547	$ 717	$ 2,581

The following tables present, by class, additional details related to loans classified as TDRs during the referenced periods, including the recorded investment in the loan both before and after modification and balances that were modified during the period:

Troubled Debt Restructurings
(dollars in thousands, unaudited)

	Three months ended June 30, 2017				
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference[1]	Reserve
Real Estate:					
1-4 family - closed-end	2	$ 43	$ 43	$ 30	$ 30
Equity Lines	3	322	322	78	6
Multi-family residential	0	-	-	-	-
Total real estate loans		365	365	108	36
Commercial and industrial	1	15	15	-	-
Consumer loans	0	-	-	-	-
		$ 380	$ 380	$ 108	$ 36

[1] This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

	Three months ended June 30, 2016				
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Reserve Difference[1]	Reserve
Real Estate:					
1-4 family - closed-end	5	$ 806	$ 806	$ 75	$ 139
Equity Lines	8	1,051	1,051	1	22
Multi-family residential	1	132	132	-	7
Total real estate loans		1,989	1,989	76	168
Commercial and industrial	0	-	-	-	-
Consumer loans	1	10	10	-	1

$ 1,999	$ 1,999	$ 76	$ 169

[1] This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

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Troubled Debt Restructurings
(dollars in thousands, unaudited)

	Six months ended June 30, 2017								
	Number of Loans		Pre-Modification Outstanding Recorded Investment		Post-Modification Outstanding Recorded Investment		Reserve Difference[1]		Reserve
Real Estate:									
Other Construction/Land	0	$	-	$	-	$	-	$	-
1-4 family - closed-end	3		90		90		32		32
Equity Lines	5		603		603		82		27
Multi-family residential	0		-		-		-		-
Commercial real estate owner occupied	0		-		-		-		-
Total real estate loans			693		693		114		59
Commercial and industrial	1		15		15		-		-
Consumer loans	0		-		-		-		-
		$	708	$	708	$	114	$	59

[1] This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

	Six months ended June 30, 2016								
	Number of Loans		Pre-Modification Outstanding Recorded Investment		Post-Modification Outstanding Recorded Investment		Reserve Difference[1]		Reserve
Real Estate:									
Other Construction/Land	1	$	17	$	17	$	-	$	2
1-4 family - closed-end	5		806		806		75		139
Equity Lines	10		1,280		1,280		-		30
Multi-family residential	1		132		132		-		7
Commercial real estate owner occupied	1		266		266		-		4
Total real estate loans			2,501		2,501		75		182
Commercial and industrial	0		-		-		-		-
Consumer loans	3		80		80		-		6
		$	2,581	$	2,581	$	75	$	188

[1] This represents the change in the ALLL reserve for these credits measured as the difference between the specific post-modification impairment reserve and the pre-modification reserve calculated under our general allowance for loan loss methodology.

The company had no finance receivables modified as TDRs within the previous twelve months that defaulted or were charged off during the three month or six month periods ended June 30, 2017 and 2016, respectively.

Purchased Credit Impaired Loans

The Company may acquire loans which show evidence of credit deterioration since origination. These purchased credit impaired ("PCI") loans are recorded at the amount paid, since there is no carryover of the seller's allowance for loan losses. Potential losses on PCI loans subsequent to acquisition are recognized by an increase in the allowance for loan losses. PCI loans are accounted for individually or are aggregated into pools of loans based on common risk characteristics. The Company projects the amount and timing of expected cash flows, and expected cash receipts in excess of the amount paid for the loan(s) are recorded as interest income over the remaining life of the loan or pool of loans (accretable yield). The excess of contractual principal and interest over expected cash flows is not recorded (nonaccretable difference). Expected cash flows are periodically re-evaluated throughout the life of the loan or pool of loans. If the present value of the expected cash flows is determined at any time to be less than the carrying amount, a reserve is recorded. If the present value of the expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

Our acquisitions of Santa Clara Valley Bank in the fourth quarter of 2014 and Coast Bancorp in the third quarter of 2016 included certain loans which have shown evidence of credit deterioration since origination, and for which it was probable at acquisition that all contractually required payments would not be collected. The carrying amount and unpaid principal balance of those PCI loans was as follows, as of the dates indicated:

Purchased Credit Impaired Loans:
(dollars in thousands, unaudited)

	June 30, 2017	
	Unpaid Principal Balance	Carrying Value
Real estate secured	$ 165	$ 53
Commercial and industrial	-	-
Total purchased credit impaired loans	$ 165	$ 53

	December 31, 2016	
	Unpaid Principal Balance	Carrying Value
Real estate secured	$ 712	$ 47
Commercial and industrial	23	-
Total purchased credit impaired loans	$ 735	$ 47

An allowance for loan losses totaling $14,000 was allocated for PCI loans as of June 30, 2017, as compared to $58,000 at December 31, 2016. We also recorded approximately $4,000 in discount accretion on PCI loans during the six months ended June 30, 2017.

<u>Note 12 – Allowance for Loan and Lease Losses</u>

The Company’s allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses. The allowance is maintained at a level that is considered adequate to absorb probable losses on certain specifically identified loans, as well as probable incurred losses inherent in the remaining loan portfolio. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when cash payments are received subsequent to the charge off. We employ a systematic methodology, consistent with FASB guidelines on loss contingencies and impaired loans, for determining the appropriate level of the allowance for loan and lease losses and adjusting it at least quarterly. Pursuant to that methodology, impaired loans and leases are individually analyzed and a criticized asset action plan is completed specifying the financial status of the borrower and, if applicable, the characteristics and condition of collateral and any associated liquidation plan. A specific loss allowance is created for each impaired loan, if necessary.

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The following tables disclose the unpaid principal balance, recorded investment, average recorded investment, and interest income recognized for impaired loans on our books as of the dates indicated. Balances are shown by loan type, and are further broken out by those that required an allowance and those that did not, with the associated allowance disclosed for those that required such. Included in the valuation allowance for impaired loans shown in the tables below are specific reserves allocated to TDRs, totaling $1.172 million at June 30, 2017 and $1.048 million at December 31, 2016.

Impaired Loans (dollars in thousands, unaudited)	June 30, 2017				
	Unpaid Principal Balance[1]	Recorded Investment[2]	Related Allowance	Average Recorded Investment	Interest Income Recognized[3]
With an allowance recorded					
Real Estate:					
Other construction/land	$378	$ 223	$ 12	$ 446	$ 5
1-4 family - closed-end	6,814	4,867	144	7,442	221
Equity lines	4,521	4,436	353	4,657	57
Multi-family residential	562	562	42	580	18
Commercial real estate- owner occupied	956	888	22	1,223	10
Commercial real estate- non-owner occupied	1,836	1,688	34	1,916	64
Total real estate	15,067	12,664	607	16,264	375
Commercial and industrial	2,636	2,636	534	2,767	48
Consumer loans	1,370	1,370	264	1,535	43
	19,073	16,670	1,405	20,566	466
With no related allowance recorded					
Real estate:					
Other construction/land	357	357	-	364	12
1-4 family - closed-end	644	582	-	659	1
Equity lines	273	244	-	309	-
Multi-family residential	-	-	-	-	-
Commercial real estate- owner occupied	1,212	1,124	-	1,450	3
Commercial real estate- non-owner occupied	10	-	-	33	-
Farmland	310	310	-	330	-
Total real estate	2,806	2,617	-	3,145	16
Commercial and industrial	47	32	-	143	-
Consumer loans	150	18	-	244	-
	3,003	2,667	-	3,532	16
Total	$22,076	$ 19,337	$ 1,405	$ 24,098	$ 482

[1]Contractual principal balance due from customer.

(2)Principal balance on Company's books, less any direct charge offs, including interest applied to principal and unaccreted discount or premium.

(3)Interest income is recognized on performing balances on a regular accrual basis.

Impaired Loans
(dollars in thousands, unaudited) December 31, 2016

	Unpaid Principal Balance[1]	Recorded Investment[2]	Related Allowance	Average Recorded Investment	Interest Income Recognized[3]
With an allowance recorded					
Real estate:					
Other construction/land	$854	$ 699	$ 20	$ 624	$ 14
1-4 family - closed-end	7,730	5,783	163	8,008	462
Equity lines	3,991	3,906	214	4,110	49
Multifamily residential	573	573	7	588	50
Commercial real estate- owner occupied	1,287	1,287	49	1,641	14
Commercial real estate- non-owner occupied	1,877	1,730	35	1,969	131
Total real estate	16,312	13,978	488	16,940	720
Agriculture	24	24	24	24	-
Commercial and industrial	2,211	2,211	608	2,652	99
Consumer loans	1,633	1,633	287	1,847	94
	20,180	17,846	1,407	21,463	913
With no related allowance recorded					
Real estate:					
Other construction/land	364	364	-	374	27
1-4 family - closed-end	666	607	-	685	3
Equity lines	544	515	-	550	-
Commercial real estate- owner occupied	999	999	-	1,773	98
Commercial real estate- non-owner occupied	77	67	-	85	-
Farmland	39	39	-	50	-
Total real estate	2,689	2,591	-	3,517	128
Agriculture	65	65	-	65	-
Commercial and industrial	62	62	-	277	-
Consumer loans	148	29	-	238	-
	2,964	2,747	-	4,097	128
Total	$23,144	$ 20,593	$ 1,407	$ 25,560	$ 1,041

(1)Contractual principal balance due from customer.

(2)Principal balance on Company’s books, less any direct charge offs, including interest applied to principal and unaccreted discount or premium.

(3)Interest income is recognized on performing balances on a regular accrual basis.

The specific loss allowance for an impaired loan generally represents the difference between the book value of the loan and either the fair value of underlying collateral less estimated disposition costs, or the loan's net present value as determined by a discounted cash flow analysis. The discounted cash flow approach is typically used to measure impairment on loans for which it is anticipated that repayment will be provided from cash flows other than those generated solely by the disposition or operation of underlying collateral. However, historical loss rates may be used to determine a specific loss allowance if they indicate a higher potential reserve need than the discounted cash flow analysis. Any change in impairment attributable to the passage of time is accommodated by adjusting the loss allowance accordingly.

For loans where repayment is expected to be provided by the disposition or operation of the underlying collateral, impairment is measured using the fair value of the collateral. If the collateral value, net of the expected costs of disposition where applicable, is less than the loan balance, then a specific loss reserve is established for the shortfall in collateral coverage. If the discounted collateral value is greater than or equal to the loan balance, no specific loss reserve is required. At the time a collateral-dependent loan is designated as nonperforming, a new appraisal is ordered and typically received within 30 to 60 days if a recent appraisal is not already available. We generally use external appraisals to determine the fair value of the underlying collateral for nonperforming real estate loans, although the Company's licensed staff appraisers may update older appraisals based on current market conditions and property value trends. Until an updated appraisal is received, the Company uses the existing appraisal to determine the amount of the specific loss allowance that may be required. The specific loss allowance is adjusted, as necessary, once a new appraisal is received. Updated appraisals are generally ordered at least annually for collateral-dependent loans that remain impaired. Current appraisals were available or in process for 99% of the Company's impaired real estate loan balances at June 30, 2017. Furthermore, the Company analyzes collateral-dependent loans on at least a quarterly basis, to determine if any portion of the recorded investment in such loans can be identified as uncollectible and would therefore constitute a confirmed loss. All amounts deemed to be uncollectible are promptly charged off against the Company's allowance for loan and lease losses, with the loan then carried at the fair value of the collateral, as appraised, less estimated costs of disposition if applicable. Once a charge-off or write-down is recorded, it will not be restored to the loan balance on the Company's accounting books.

Our methodology also provides for the establishment of a "general" allowance for probable incurred losses inherent in loans and leases that are not impaired. Unimpaired loan balances are segregated by credit quality, and are then evaluated in pools with common characteristics. At the present time, pools are based on the same segmentation of loan types presented in our regulatory filings. While this methodology utilizes historical loss data and other measurable information, the credit classification of loans and the establishment of the allowance for loan and lease losses are both to some extent based on Management's judgment and experience. Our methodology incorporates a variety of risk considerations, both quantitative and qualitative, in establishing an allowance for loan and lease losses that Management believes is appropriate at each reporting date. Quantitative information includes our historical loss experience, delinquency and charge-off trends, and current collateral values. Qualitative factors include the general economic environment in our markets and, in particular, the condition of the agricultural industry and other key industries. Lending policies and procedures (including underwriting standards), the experience and abilities of lending staff, the quality of loan review, credit concentrations (by geography, loan type, industry and collateral type), the rate of loan portfolio growth, and changes in legal or regulatory requirements are additional factors that are considered. The total general reserve established for probable incurred losses on unimpaired loans was $7.825 million at June 30, 2017.

There were no material changes to the methodology used to determine our allowance for loan and lease losses during the three months ended June 30, 2017, although in recognition of relatively low loan loss rates in recent periods, upward adjustments were made to qualitative factor multipliers earlier in 2017. As we add new products and expand our geographic coverage, and as the economic environment changes, we expect to enhance our methodology to keep pace with the size and complexity of the loan and lease portfolio and respond to pressures created by external forces. We engage outside firms on a regular basis to assess our methodology and perform independent credit reviews of our loan and lease portfolio. In addition, the Company's external auditors, the FDIC, and the California DBO review the allowance for loan and lease losses as an integral part of their audit and examination processes. Management believes that the current methodology is appropriate given our size and level of complexity.

The tables that follow detail the activity in the allowance for loan and lease losses for the periods noted:

Allowance for Credit Losses and Recorded Investment in Financing Receivables

(dollars in thousands, unaudited)

	Three months ended June 30, 2017					
	Real Estate	Agricultural Production	Commercial and Industrial	Consumer	Unallocated	Total
Allowance for credit losses:						
Beginning Balance	$4,112	$ 242	$ 3,507	$ 1,211	$ 516	$9,588
Charge-offs	(58)	(22)	(354)	(531)	-	(965)
Recoveries	42	2	34	229	-	307
Provision	8	21	265	240	(234)	300
Ending Balance	$4,104	$ 243	$ 3,452	$ 1,149	$ 282	$9,230

	Six months ended June 30, 2017					
	Real Estate	Agricultural Production	Commercial and Industrial	Consumer	Unallocated	Total
Allowance for credit losses:						
Beginning Balance	$3,548	$ 209	$ 4,279	$ 1,208	$ 457	$9,701
Charge-offs	(144)	(22)	(384)	(1,046)	-	(1,596)
Recoveries	145	5	195	480	-	825
Provision	555	51	(638)	507	(175)	300
Ending Balance	$4,104	$ 243	$ 3,452	$ 1,149	$ 282	$9,230
Reserves:						
Specific	$607	$ -	$ 534	$ 264	$ -	$1,405
General	3,497	243	2,918	885	282	7,825
Ending Balance	$4,104	$ 243	$ 3,452	$ 1,149	$ 282	$9,230
Loans evaluated for impairment:						
Individually	$15,281	$ -	$ 2,668	$ 1,388	$ -	$19,337
Collectively	973,077	54,436	242,863	9,526	-	1,279,902
Ending Balance	$988,358	$ 54,436	$ 245,531	$ 10,914	$ -	$1,299,239

Year ended December 31, 2016

	Real Estate	Agricultural Production	Commercial and Industrial	Consumer	Unallocated	Total
Allowance for credit losses:						
Beginning Balance	$4,783	$ 722	$ 2,533	$ 1,263	$ 1,122	$10,423
Charge-offs	(962)	-	(344)	(1,905)	-	(3,211)
Recoveries	983	14	477	1,015	-	2,489
Provision	(1,256)	(527)	1,613	835	(665)	-
Ending Balance	$3,548	$ 209	$ 4,279	$ 1,208	$ 457	$9,701
Reserves:						
Specific	$488	$ 24	$ 608	$ 287	$ -	$1,407
General	3,060	185	3,671	921	457	8,294
Ending Balance	$3,548	$ 209	$ 4,279	$ 1,208	$ 457	$9,701
Loans evaluated for impairment:						
Individually	$16,569	$ 89	$ 2,273	$ 1,662	$ -	$20,593
Collectively	900,928	46,140	284,367	10,503	-	1,241,938
Ending Balance	$917,497	$ 46,229	$ 286,640	$ 12,165	$ -	$1,262,531

<u>Note 13 – Recent Developments</u>

On July 5, 2017, Bank of the Sierra, the banking subsidiary of Sierra Bancorp, entered into an agreement with Citizens Business Bank, the banking subsidiary of CVB Financial Corp., to acquire the Citizens branch located in Woodlake, California. The transaction is expected to close in the fourth quarter of 2017, subject to the receipt of all required regulatory approvals. Subsequent to the acquisition, it is anticipated that the Woodlake branch will continue to operate as a full-service branch of Bank of the Sierra. At May 31, 2017 Woodlake branch deposits totaled approximately $27 million, consisting largely of non-maturity deposits. Bank of the Sierra already has a number of deposits in the Woodlake zip code that are domiciled at nearby branches, thus this branch purchase is intended to enhance the level of service for current customers as well as provide additional core deposits for the Bank. The acquisition agreement also contemplates that Bank of the Sierra will purchase the Woodlake branch building, the real property on which the building is located, and certain other equipment and fixed assets at their aggregate fair value of $500,000.

On April 24, 2017, the Company announced the signing of a definitive agreement to acquire OCB Bancorp ("Ojai"), the holding company for Ojai Community Bank. We expect the transaction to be completed in October 2017, subject to customary closing conditions including the receipt of required regulatory approvals and the consent of OCB Bancorp shareholders. Immediately following the acquisition, Ojai Community Bank will be merged with and into Bank of the Sierra. Ojai Community Bank has its main office in Ojai, California, and also maintains branch offices in Ventura, Santa Paula, and Santa Barbara, conducting business in those communities as Ventura Community Bank, Santa Paula Community Bank, and Santa Barbara Community Bank, respectively.

The Company acquired Coast Bancorp ("Coast"), the holding company for Coast National Bank, on July 8, 2016, and immediately following the acquisition Coast National Bank was merged with and into Bank of the Sierra. Coast National Bank was a community bank with branch offices in San Luis Obispo, Paso Robles, and Arroyo Grande, and a loan production office in Atascadero, California. Shortly after transaction closing, the Atascadero location was converted into a full-service branch office. At the acquisition date, the fair value of Coast's loans totaled $94 million and deposits totaled $129 million. The acquisition also involved $7 million in trust preferred securities, which were booked by the Company at their fair value of $3.4 million. This acquisition had, and will continue to have, a material impact on comparative 2017 and 2016 average balances and associated income and expense. Furthermore, one-time acquisition costs added over $2.4 million to the Company's pre-tax non-interest expense in the latter half of 2016.

PART I - FINANCIAL INFORMATION

ITEM 2

MANAGEMENT'S DISCUSSION AND

ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Form 10-Q includes forward-looking statements that involve inherent risks and uncertainties. Words such as "expects", "anticipates", "believes", "projects", and "estimates" or variations of such words and similar expressions are intende to identify forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed, forecast in, or implied by such forward-looking statements.

A variety of factors could have a material adverse impact on the Company's financial condition or results of operations, and should be considered when evaluating the Company's potential future financial performance. They include, but are not limited to, the risk of unfavorable economic conditions in the Company's market areas; risks associated with fluctuations in interest rates; liquidity risks; increases in nonperforming assets and credit losses that could occur, particularly in times of weak economic conditions or rising interest rates; reductions in the market value of available-for-sale securities that could result if interest rates increase substantially or an issuer has real or perceived financial difficulties; the Company's ability to attract and retain skilled employees; the Company's ability to successfully deploy new technology; the success of acquisitions or branch expansion; and risks associated with the multitude of current and prospective laws and regulations to which the Company is and will be subject. Risk factors that could cause actual results to differ materially from results that might be implied by forward-looking statements include the risk factors disclosed in the Company's Form 10-K for the fiscal year ended December 31, 2016.

CRITICAL ACCOUNTING POLICIES

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and incorporate various assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company’s stated results of operations. In Management’s opinion, the Company’s critical accounting policies deal with the following areas: the establishment of the allowance for loan and lease losses, as explained in detail in Note 12 to the consolidated financial statements and in the “Provision for Loan and Lease Losses” and “Allowance for Loan and Lease Losses” sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, as discussed in Note 11 to the consolidated financial statements; income taxes and deferred tax assets and liabilities, especially with regard to the ability of the Company to recover deferred tax assets as discussed in the “Provision for Income Taxes” and “Other Assets” sections of this discussion and analysis; and goodwill and other intangible assets, which are evaluated annually for impairment and for which we have determined that no impairment exists, as discussed in the “Other Assets” section of this discussion and analysis. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company’s financial statements incorporate our most recent expectations with regard to those areas.

OVERVIEW OF THE RESULTS OF OPERATIONS

AND FINANCIAL CONDITION

results of operations Summary

Second Quarter 2017 compared to Second Quarter 2016

Net income for the quarter ended June 30, 2017 was $5.202 million, representing an increase of $1.116 million, or 27%, relative to net income of $4.086 million for the quarter ended June 30, 2016. Basic and diluted earnings per share for the second quarter of 2017 were $0.38 and $0.37, respectively, compared to $0.31 basic and diluted earnings per share for the second quarter of 2016. The Company's annualized return on average equity was 9.75% and annualized return on average assets was 1.02% for the quarter ended June 30, 2017, compared to 8.38% and 0.93%, respectively, for the quarter ended June 30, 2016. The primary drivers behind the variance in second quarter net income are as follows:

- Net interest income was up by $2.645 million, or 17%, due to growth in average interest-earning assets totaling $260 million, or 16%, as well as improvement of four basis points in our net interest margin.

- The Company recorded a provision for loan losses in the second quarter of 2017, for the first time since the second quarter of 2014. The $300,000 provision became necessary due to loan growth, and to replenish reserves subsequent to an unanticipated charge-off.

- Total non-interest income increased by $790,000, or 17%, due to a $298,000 increase in service charges on deposits, a $129,000 increase in bank-owned life insurance (BOLI) income resulting primarily from higher income on BOLI associated with deferred compensation plans, and a $363,000 increase in other non-interest income that includes a $141,000 prepayment penalty on a large loan that paid off in the second quarter of 2017 and a rising level of non-deposit service charges and fees, particularly debit card interchange income.

- Total non-interest expense reflects an increase of $1.376 million, or 10%, due in large part to ongoing costs stemming from our acquisition of Coast Bancorp ("Coast") in July of 2016 and recent de novo branch openings. There were other large variances within non-interest expense, including certain nonrecurring items, which are discussed in greater detail in the "Non-Interest Income and Non-Interest Expense" section of this Management Discussion and Analysis.

- The Company's provision for income taxes was 33% of pre-tax income in the second quarters of both 2017 and 2016.

First Half 2017 compared to First Half 2016

Net income for the first half of 2017 was $9.754 million, representing an increase of $1.632 million, or 20%, relative to net income of $8.122 million for the first half of 2016. Basic and diluted earnings per share for the first half of 2017 were $0.71 and $0.70, respectively, compared to $0.61 basic and diluted earnings per share for the first half of 2016. The Company's annualized return on average equity was 9.31% and annualized return on average assets was 0.98% for the six months ended June 30, 2017, compared to a return on equity of 8.39% and return on assets of 0.93% for the six months ended June 30, 2016. The primary drivers behind the variance in year-to-date net income are as follows:

- Net interest income increased $4.213 million, or 14%, due to the positive impact of a $232 million increase in average interest-earning assets.

- As noted above, the Company recorded a $300,000 provision for loan losses in the first half of 2017, relative to no provision in 2016.

- Total non-interest income was up $1.630 million, or 18%, due to a $500,000 increase in service charges on deposits, a $372,000 increase in bank-owned life insurance (BOLI) income, and a $758,000 increase in other non-interest income that includes the aforementioned loan prepayment penalty in the second quarter of 2017 and a higher level of non-deposit service charges and fees, including debit card interchange income.

- Total non-interest expense increased by $3.598 million, or 13%, due in large part to the Coast acquisition and recent branch openings; other significant variances are detailed below.

- The Company's provision for income taxes was 31% of pre-tax income for the first half of 2017, relative to 33% for the first half of 2016. The lower tax accrual rate in 2017 is primarily the result of our adoption of FASB's Accounting Standards Update 2016-09 effective January 1, 2017, and the subsequent change in accounting methodology associated with the disqualifying disposition of Company shares issued pursuant to the exercise of incentive stock options (ISOs).

Financial Condition Summary

June 30, 2017 relative to December 31, 2016

The Company's assets totaled $2.078 billion at June 30, 2017, relative to total assets of $2.033 billion at December 31, 2016. Total liabilities were $1.862 billion at June 30, 2017 compared to $1.827 billion at the end of 2016, and shareholders' equity totaled $216 million at June 30, 2017 compared to $206 million at December 31, 2016. The following provides a summary of key balance sheet changes during the first six months of 2017:

- Cash balances were down $43 million, or 36%, including a $15 million reduction in non-earning balances.
- Investment securities were up $49 million, or 9%, due in part to the longer-term investment of cash balances.
- Gross loans increased by $37 million, or 3%, due to strong organic growth in real estate loans and agricultural production loans. Loan growth would have been greater if not for the payoff of a $7 million dairy loan in the second quarter of 2017, and a drop of $36 million in mortgage warehouse loans.
- Total nonperforming assets, namely non-accrual loans and foreclosed assets, were reduced by $797,000, or 9%. The Company's ratio of nonperforming assets to total loans plus foreclosed assets was 0.60% at June 30, 2017, compared to 0.68% at December 31, 2016 and 0.76% at June 30, 2016.
- Deposit balances reflect net growth of $96 million, or 6%, due in large part to continued organic growth in core non-maturity deposits.
- Junior subordinated debentures increased slightly from the accretion of the discount on trust-preferred securities acquired from Coast, but other borrowings were reduced by $62 million, or 85%, due to exceptional deposit growth.
- Total capital reflects an increase of slightly over $10 million, or 5%, due to the addition of income, the impact of stock options exercised, and a $3 million absolute increase in accumulated other comprehensive income, net of dividends paid. Our consolidated total risk-based capital ratio was 17.18% at June 30, 2017 as compared to 17.25% at year-end 2016, and our regulatory capital ratios remain very strong relative to peer banks.

EARNINGS PERFORMANCE

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on deposits and other borrowed money. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expense is comprised of operating costs that facilitate offering a full range of banking services to our customers.

Net interest income AND NET INTEREST MARGIN

Net interest income increased by $2.645 million, or 17%, for the second quarter of 2017 relative to the second quarter of 2016 and by $4.213 million, or 14%, for the first half of 2017 compared to the first half of 2016. The level of net interest income we recognize in any given period depends on a combination of factors including the average volume and yield for interest-earning assets, the average volume and cost of interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income is also impacted by the reversal of interest for loans placed on non-accrual status during the reporting period, and the recovery of interest on loans that had been on non-accrual and were paid off, sold or returned to accrual status.

The following tables show average balances for significant balance sheet categories and the amount of interest income or interest expense associated with each category for the noted periods. The tables also display calculated yields on each major component of the Company's investment and loan portfolios, average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin for the noted periods.

Average Balances and Rates (dollars in thousands, unaudited)	For the three months ended Ended June 30, 2017				For the three months ended Ended June 30, 2016			
	Average Balance [1]	Income/ Expense	Average Rate/Yield [2]		Average Balance [1]	Income/ Expense	Average Rate/Yield [2]	
Assets								
Investments:								
Federal funds sold/due from time	$53,965	$139	1.02	%	$4,830	$5	0.41	%
Taxable	435,935	2,141	1.94	%	417,881	2,052	1.94	%
Non-taxable	131,972	932	4.30	%	104,548	730	4.25	%
Equity	1,535	6	1.55	%	1,177	-	-	
Total investments	623,407	3,218	2.36	%	528,436	2,787	2.38	%
Loans and Leases:[3]								
Real estate	969,925	12,207	5.05	%	776,172	9,567	4.96	%
Agricultural	50,942	620	4.88	%	47,184	520	4.43	%
Commercial	116,719	1,577	5.42	%	107,342	1,257	4.71	%
Consumer	11,577	307	10.64	%	14,152	421	11.97	%
Mortgage warehouse lines	97,191	1,077	4.44	%	137,937	1,353	3.95	%
Other	3,309	49	5.94	%	1,951	29	5.98	%
Total loans and leases	1,249,663	15,837	5.08	%	1,084,738	13,147	4.87	%
Total interest earning assets [4]	1,873,070	19,055	4.19	%	1,613,174	15,934	4.07	%
Other earning assets	8,689				7,853			
Non-earning assets	156,643				137,025			
Total assets	$2,038,402				$1,758,052			
Liabilities and shareholders' equity								
Interest bearing deposits:								
Demand deposits	$157,482	$122	0.31	%	$146,686	$110	0.30	%
NOW	374,304	104	0.11	%	314,556	78	0.10	%
Savings accounts	228,859	58	0.10	%	202,011	56	0.11	%
Money market	118,172	23	0.08	%	97,971	16	0.07	%
CDAR's	-	-	-		2,074	-	-	
Certificates of deposit, under $100,000	72,736	67	0.37	%	73,913	57	0.31	%
Certificates of deposit, $100,000 or more	268,706	494	0.74	%	222,547	191	0.35	%
Total interest bearing deposits	1,220,259	868	0.29	%	1,059,758	508	0.19	%
Borrowed Funds:								
Federal funds purchased	3	-	-		1,399	3	0.86	%
Repurchase agreements	10,229	10	0.39	%	9,989	10	0.40	%
Short term borrowings	1	-	-		17,273	18	0.42	%
TRUPS	34,475	337	3.92	%	30,928	200	2.60	%
Total borrowed funds	44,708	347	3.11	%	59,589	231	1.56	%
Total interest bearing liabilities	1,264,967	1,215	0.39	%	1,119,347	739	0.27	%
Demand deposits - non-interest bearing	533,570				427,581			
Other liabilities	25,945				14,918			
Shareholders' equity	213,920				196,206			

Total liabilities and shareholders' equity	$2,038,402			$1,758,052		
Interest income/interest earning assets		4.19	%		4.07	%
Interest expense/interest earning assets		0.26	%		0.18	%
Net interest income and margin[5]	$17,840	3.93	%	$15,195	3.89	%

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(2) Yields and net interest margin have been computed on a tax equivalent basis utilizing a 35% effective tax rate.

(3) Loans are gross the allowance for possible loan losses. Net loan fees have been been included in the calculation of interest income. Net loan fees and loan acquisition FMV amortization were $(67) thousand and $109 thousand for the quarters ended June 30, 2017 and 2016.

(4) Non-accrual loans are slotted by loan type and have been included in total loans for purposes of total earning assets.

(5) Net interest margin represents net interest income as a percentage of average interest-earning assets.

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Average Balances and Rates (dollars in thousands, unaudited)	For the six months ended June 30, 2017				For the six months ended June 30, 2016			
	Average Balance (1)	Income/ Expense	Average Rate/Yield (2)		Average Balance (1)	Income/ Expense	Average Rate/Yield (2)	
Assets								
Investments:								
Federal funds sold/due from time	$55,304	$255	0.92	%	$12,389	$32	0.51	%
Taxable	430,380	4,149	1.92	%	413,424	4,199	2.01	%
Non-taxable	124,055	1,737	4.28	%	103,261	1,460	4.30	%
Equity	1,569	11	1.39	%	1,215	36	5.86	%
Total Investments	611,308	6,152	2.31	%	530,289	5,727	2.43	%
Loans and Leases:(3)								
Real Estate	948,845	23,814	5.06	%	775,248	19,356	5.02	%
Agricultural	49,235	1,176	4.82	%	46,504	1,022	4.42	%
Commercial	118,388	3,076	5.24	%	107,898	2,504	4.67	%
Consumer	11,835	654	11.14	%	14,486	823	11.43	%
Mortgage Warehouse Lines	93,630	1,995	4.30	%	127,502	2,471	3.90	%
Other	3,145	91	5.83	%	1,989	64	6.47	%
Total Loans and Leases	1,225,078	30,806	5.07	%	1,073,627	26,240	4.91	%
Total Interest Earning Assets (4)	1,836,386	36,958	4.16	%	1,603,916	31,967	4.11	%
Other Earning Assets	8,598				7,700			
Non-Earning Assets	155,948				135,831			
Total Assets	$2,000,932				$1,747,447			
Liabilities and Shareholders' Equity								
Interest Bearing Deposits:								
Demand Deposits	$146,162	$223	0.31	%	$136,829	$205	0.30	%
NOW	371,474	206	0.11	%	311,085	166	0.11	%
Savings Accounts	225,174	121	0.11	%	199,463	109	0.11	%
Money Market	119,264	45	0.08	%	98,600	32	0.07	%
CDAR's	64	-	-		7,072	2	0.06	%
Certificates of Deposit, under $100,000	73,714	124	0.34	%	74,246	114	0.31	%
Certificates of Deposit, $100,000 or more	268,298	838	0.63	%	220,985	371	0.34	%
Total Interest Bearing Deposits	1,204,150	1,557	0.26	%	1,048,280	999	0.19	%
Borrowed Funds:								
Federal Funds Purchased	3	-	-		700	3	0.86	%
Repurchase Agreements	9,199	18	0.39	%	9,463	19	0.40	%
Short Term Borrowings	820	3	0.74	%	16,640	34	0.41	%
Long Term Borrowings	-	-	-		615	-	-	
TRUPS	34,451	657	3.85	%	30,928	402	2.61	%
Total Borrowed Funds	44,473	678	3.07	%	58,346	458	1.58	%
Total Interest Bearing Liabilities	1,248,623	2,235	0.36	%	1,106,626	1,457	0.26	%
Demand deposits- non interest bearing	514,718				431,572			
Other liabilities	26,379				14,659			

Shareholders' equity	211,212				194,590		
Total liabilities and shareholders' equity	$2,000,932				$1,747,447		
Interest Income/Interest Earning Assets			4.16	%			4.11	%
Interest Expense/Interest Earning Assets			0.24	%			0.19	%
Net Interest Income and Margin[5]		$34,723	3.92	%		$30,510	3.92	%

[1] Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

[2] Yields and net interest margin have been computed on a tax equivalent basis utilizing a 35% effective tax rate.

[3] Loans are gross of the allowance for possible loan losses. Net loan fees have been included in the calculation of interest income. Net loan fees and loan acquistion FMV amortization were $(80) thousand and $164 thousand for the six months ended June 30, 2017 and 2016.

[4] Non-accrual loans are slotted by loan type and have been included in total loans for purposes of total earning assets.

[5] Net interest margin represents net interest income as a percentage of average interest-earning assets.

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The Volume and Rate Variances table below sets forth the dollar difference for the comparative periods in interest earned or paid for each major category of interest-earning assets and interest-bearing liabilities, and the amount of such change attributable to fluctuations in average balances (volume) or differences in average interest rates. Volume variances are equal to the increase or decrease in average balances multiplied by prior period rates, and rate variances are equal to the change in rates multiplied by prior period average balances. Variances attributable to both rate and volume changes, calculated by multiplying the change in rates by the change in average balances, have been allocated to the rate variance.

Volume & Rate Variances (dollars in thousands, unaudited)	Three months ended June 30, 2017 over 2016 Increase(decrease) due to			Six months ended June 30, 2017 over 2016 Increase(decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
Assets:						
Investments:						
Federal funds sold / Due from time	$ 51	$ 83	$ 134	$ 111	$ 112	$ 223
Taxable	89	-	89	172	(222)	(50)
Non-taxable[1]	191	11	202	294	(17)	277
Equity	-	6	6	10	(35)	(25)
Total Investments	331	100	431	587	(162)	425
Loans and Leases:						
Real Estate	2,388	252	2,640	4,334	124	4,458
Agricultural	41	59	100	60	94	154
Commercial	110	210	320	243	329	572
Consumer	(77)	(37)	(114)	(151)	(18)	(169)
Mortgage Warehouse	(400)	124	(276)	(656)	180	(476)
Other	20	-	20	37	(10)	27
Total Loans and Leases	2,082	608	2,690	3,867	699	4,566
Total Interest Earning Assets	$ 2,413	$ 708	$ 3,121	$ 4,454	$ 537	$ 4,991
Liabilities						
Interest Bearing Deposits:						
Demand Deposits	$ 8	$ 4	$ 12	$ 14	$ 4	$ 18
NOW	15	11	26	32	8	40
Savings Accounts	7	(5)	2	14	(2)	12
Money Market	3	4	7	7	6	13
CDAR’s	-	-	-	(2)	-	(2)
Certificates of Deposit < $100,000	(1)	11	10	(1)	11	10
Certificates of Deposit ≥ $100,000	40	263	303	79	388	467
Total Interest Bearing Deposits	72	288	360	143	415	558
Borrowed Funds:						
Federal Funds Purchased	(3)	-	(3)	(3)	-	(3)
Repurchase Agreements	-	-	-	(1)	-	(1)
Short Term Borrowings	(18)	-	(18)	(32)	1	(31)
TRUPS	23	114	137	46	209	255
Total Borrowed Funds	2	114	116	10	210	220
Total Interest Bearing Liabilities	74	402	476	153	625	778

Net Interest Income	$ 2,339	$ 306	$ 2,645	$ 4,301	$ (88)	$ 4,213

(1) Yields on tax exempt income have not been computed on a tax equivalent basis.

The volume variance calculated for the second quarter of 2017 relative to the second quarter of 2016 was a favorable $2.339 million, due to an increase of $260 million, or 16%, in the average balance of interest-earning assets resulting from growth in loans and investments, including the impact of the Coast acquisition. There was also a favorable rate variance of $306,000 for the second quarter comparison. Our weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities were both up by 12 basis points, but there was a net benefit to the Company because the yield increase on earning assets was applied to a much higher balance than the rate change for interest-bearing liabilities. Loan yields have risen in response to the impact of higher short-term interest rates on our variable-rate loans, discount accretion on loans from the Coast acquisition, and an increase in non-recurring interest income. Nonrecurring interest income, primarily in the form of interest recovered on non-accrual loans net of interest reversed on loans placed on non-accrual status, totaled $83,000 in the second quarter of 2017 relative to $22,000 in the second quarter of 2016. Our weighted average cost of interest-bearing liabilities increased primarily because of higher rates paid on adjustable-rate trust-preferred securities ("TRUPS"), short-term borrowings and large time deposits.

The Company's net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, was affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 3.93% in the second quarter of 2017, up four basis points relative to the second quarter of 2016 primarily as the result of higher loan yields.

Net interest income in the first half of 2017 relative to the first half of 2016 reflects a favorable variance of $4.301 million attributable to volume changes, and an unfavorable rate variance of $88,000. The volume variance for the half was due primarily to an increase of $232 million, or 14%, in average interest-earning assets. The negative rate variance for the half is the result of a 10 basis point increase in our average cost of interest-bearing liabilities, relative to only a five basis point increase in our average yield on earning assets. As with the quarterly comparison, the year-to-date rate variance was favorably impacted by nonrecurring interest income, with totaled $219,000 for the first six months of 2017 but added just $65,000 to interest income for the first six months of 2016. The Company's net interest margin for the first half of 2017 was 3.92%, the same as our net interest margin in the first half of 2016.

Provision for loan and LEASE losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses, a contra-asset account, through periodic charges to earnings which are reflected in the income statement as the provision for loan and lease losses. The Company recorded a provision for loan losses in the second quarter of 2017, for the first time since the second quarter of 2014. The $300,000 provision became necessary due to loan growth, and to replenish reserves subsequent to the unanticipated charge-off of a $224,000 overdraft on a business account. Specifically identifiable and quantifiable loan losses are immediately charged off against the allowance. The Company recorded $658,000 in net loan balances charged off in the second quarter of 2017 relative to $12,000 in net recoveries in the second quarter of 2016, and net charge-offs were $771,000 in the first six months of 2017 relative to $381,000 in the first six months of 2016.

With the loan loss provision recorded in the second quarter of 2017, we were able to maintain our allowance for loan and lease losses at a level that, in Management's judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans as well as probable incurred losses in the remaining loan portfolio. The need for reserve replenishment via a loan loss provision has been minimized in recent periods due to the following factors: all of our acquired loans were booked at their fair values on the acquisition date, and thus did not initially require a loan loss allowance; with the notable exception of the overdraft charge-off noted in the previous paragraph, charge-offs have primarily been recorded against pre-established reserves which alleviated what otherwise might have been a need for reserve replenishment; organic growth in our performing loan portfolio has been concentrated in loan types with low historical loss rates, and loss rates for most loan types have been declining, thus having a positive impact on general reserves for performing loans; and, new loans booked during and since the great recession have been underwritten using tighter credit standards than was the case for many legacy loans.

The Company's policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed in Note 12 to the consolidated financial statements and below under "Allowance for Loan and Lease Losses." The process utilized to establish an appropriate allowance for loan and lease losses can result in a high degree of variability in the Company's loan loss provision, and consequently in our net earnings.

NON-INTEREST INCOME and NON-INTEREST expense

The following table provides details on the Company's non-interest income and non-interest expense for the three- and six-month periods ended June 30, 2017 and 2016:

Non-Interest Income/Expense

(dollars in thousands, unaudited)

	For the three months ended June 30,				For the six months ended June 30,			
	2017	% of Total	2016	% of Total	2017	% of Total	2016	% of Total
NON-INTEREST INCOME:								
Service charges on deposit accounts	$2,776	51.75 %	$2,478	54.18 %	$5,348	50.94 %	$4,848	54.66 %
Other service charges, commissions & fees	2,212	41.24 %	1,783	38.98 %	4,245	40.44 %	3,593	40.52 %
Gains on securities	58	1.08 %	146	3.19 %	66	0.63 %	122	1.38 %
Bank owned life insurance	358	6.67 %	229	5.01 %	811	7.73 %	439	4.95 %
Other	(40)	-0.74 %	(62)	-1.36 %	28	0.26 %	(134)	-1.51 %
Total non-interest income	$5,364	100.00%	$4,574	100.00%	$10,498	100.00%	$8,868	100.00%
As a % of average interest-earning assets (1)		1.15 %		1.14 %		1.15 %		1.12 %
OTHER OPERATING EXPENSE:								
Salaries and employee benefits	$7,253	48.06 %	$6,624	48.28 %	$15,138	49.16 %	$13,490	49.61 %
Occupancy costs								
Furniture & equipment	562	3.72 %	596	4.35 %	1,247	4.05 %	1,163	4.28 %
Premises	1,673	11.09 %	1,270	9.26 %	3,308	10.74 %	2,454	9.02 %
Advertising and marketing costs	605	4.01 %	695	5.07 %	1,123	3.65 %	1,184	4.35 %
Data processing costs	1,071	7.10 %	861	6.28 %	2,009	6.52 %	1,627	5.98 %
Deposit services costs	1,178	7.81 %	861	6.28 %	2,111	6.86 %	1,722	6.33 %
Loan services costs								
Loan processing	189	1.25 %	192	1.40 %	439	1.43 %	359	1.32 %
Foreclosed assets	23	0.15 %	319	2.33 %	164	0.53 %	450	1.65 %
Other operating costs								
Telephone & data communications	450	2.98 %	366	2.67 %	873	2.84 %	749	2.75 %

Postage & mail	221	1.46 %	226	1.65 %	479	1.56 %	453	1.67 %
Other	283	1.88 %	230	1.68 %	532	1.71 %	386	1.42 %
Professional services costs								
Legal & accounting	511	3.39 %	425	3.10 %	933	3.03 %	850	3.13 %
Acquistion Cost	166	1.10 %	128	0.93 %	161	0.52 %	342	1.26 %
Other professional service	442	2.93 %	487	3.55 %	1,326	4.31 %	868	3.19 %
Stationery & supply costs	305	2.02 %	231	1.68 %	633	2.06 %	650	2.39 %
Sundry & tellers	159	1.05 %	204	1.49 %	316	1.03 %	447	1.65 %
Total non-interest expense	$15,091	100.00%	$13,715	100.00%	$30,792	100.00%	$27,194	100.00%
As a % of average interest-earning assets (1)		3.23 %		3.42 %		3.36 %		3.43 %
Efficiency Ratio (2)	63.30 %		68.10 %		66.18 %		67.51 %	

(1) Annualized

(2) Tax Equivalent

Total non-interest income increased by $790,000, or 17%, for the second quarter of 2017 over the second quarter of 2016, and by $1.630 million, or 18%, for the first half of 2017 relative to the first half of 2016. Both the second quarter and first six months of 2017 saw a higher level of service charges on deposits, an increase in bank-owned life insurance (BOLI) income, and additional non-deposit service charges and fees, including a $141,000 prepayment penalty on a large dairy loan that paid off in the second quarter of 2017. The year-to-date comparison also reflects higher dividends on restricted stock. Total non-interest income was an annualized 1.15% of average interest-earning assets in the second quarter of 2017 relative to 1.14% in the second quarter of 2016, and was 1.15% for the first half of 2017 relative to 1.12% in the first half of 2016.

Service charge income on deposits increased by $298,000, or 12%, for the second quarter comparison and $500,000, or 10%, for the first six months due primarily to fees earned from accounts added over the past year, including from the Coast acquisition. The increase a