

Oak Valley Bancorp  
Form 10-K  
March 28, 2013  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

**x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934**

**For the fiscal year ended December 31, 2012**

**OR**

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

**OAK VALLEY BANCORP**

(Exact name of registrant as specified in its charter)

**California**  
(State or other jurisdiction  
of incorporation or organization)

**26-2326676**  
(I.R.S. Employer  
Identification No.)

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**125 North Third Avenue**  
**Oakdale, California**  
(Address of principal executive offices)

**95361**  
(Zip Code)

**(209) 848-2265**

(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:

| <b>Title of each class</b> | <b>Name of each exchange on which registered</b> |
|----------------------------|--|
| Common Stock               | The NASDAQ Stock Market, LLC                     |

Securities registered pursuant to Section 12(g) of the Act:

**None**

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes  No

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  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 (232.405 of this chapter during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

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

As of December 31, 2012, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant, based upon the closing price per share of the registrant's common stock as reported by the NASDAQ, was approximately \$50 million. As of March 19, 2013, there were 7,914,730 shares of common stock outstanding.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on June 4, 2013 are incorporated by reference into Part III.

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**PART I**

**ITEM 1. BUSINESS OF OAK VALLEY BANCORP**

**Overview of the Business**

*Oak Valley Bancorp.* Oak Valley Bancorp (the Company) was incorporated on April 1, 2008 in California for the purpose of becoming Oak Valley Community Bank's parent bank holding company. Effective July 3, 2008, Oak Valley Bancorp acquired all of the outstanding capital stock of Oak Valley Community Bank (the Bank) (from time to time, the Bank and the Company may be generally referred to as we, us or our). The principal office of Oak Valley Bancorp is located at 125 North Third Avenue, Oakdale, California 95361 and its principal telephone is (209) 848-2265.

The Company is authorized to issue 50,000,000 shares of common stock, without par value, of which 7,907,780 are issued and outstanding at December 31, 2012, and 10,000,000 shares of preferred stock, without par value, of which 6,750 Series B preferred stock shares are issued and outstanding.

The Company is the holding company of the Bank, and its only asset is the outstanding capital stock of the Bank, which the Company wholly owns.

*Oak Valley Community Bank.* The Bank commenced operations in May 1991. The Bank is an insured bank under the Federal Deposit Insurance Act and is a member of the Federal Reserve. The Bank is subject to regulation, supervision and regular examination by the California Department of Financial Institutions (DFI), the Federal Deposit Insurance Commission (FDIC) and the Federal Reserve Board (FRB). Since its formation, the Bank has provided basic banking services to individuals and business enterprises in Oakdale, California and the surrounding areas. The focus of the Bank is to offer a range of commercial banking services designed for both individuals and small to medium-sized businesses in the two main areas of service of the Bank: the Central Valley and the Eastern Sierras.

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

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

## Expansion

*Branch Expansion.* Over the past few years, our network of branches and loan production offices have been expanded geographically. As of December 31, 2012, we maintained fourteen full-service branch offices (in addition to our corporate headquarters). Beginning in October 1995, we started our geographic expansion outside of Oakdale, by opening a Loan Production Office in Sonora, California. We subsequently opened a branch in Sonora and two branches in Modesto. In September 2000, we expanded into the Eastern Sierra, opening a branch in Bridgeport, California under the name Eastern Sierra Community Bank. Since that time we have added branches in Mammoth Lakes and Bishop. During 2005 and 2006, we aggressively increased our presence in the Central Valley, by opening branches in Turlock, Stockton, Patterson, Ripon and Escalon. In March 2007, our corporate headquarters expanded by adding an adjacent historical building located in downtown Oakdale to its complex. In 2011, we opened a third branch in Modesto and a branch in Manteca. We intend to continue our growth strategy in future years through the opening of additional branches and loan production offices as our needs and resources permit.

*Bank Holding Company Reorganization.* Effective July 3, 2008, we entered into a bank holding company reorganization, whereby each outstanding share of common stock of the Bank was exchanged into a share of common stock of the Company. Operating our banking business within a holding company structure provides, among other things, greater operating flexibility; facilitates the potential acquisition of related businesses as opportunities may arise from time to time; improves our ability to diversify as needed; enhances our ability to remain competitive in the future with other companies in the financial services industry that are organized in a holding company structure; and improves our ability to raise capital to support growth.

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**Business Segments**

The Bank operates in two primary business segments: Retail Banking and Commercial Banking, as described in additional detail below. These segments do not meet the quantitative thresholds for reporting as separate segments and are therefore considered one segment for financial reporting purposes:

*Retail Banking.* We offer a range of checking and savings accounts, including NOW accounts, money market accounts, overdraft protection, health savings accounts, certificates of deposit, and Individual Retirement Accounts ( IRA ). To satisfy the lending needs of individuals in its service area, we offer real estate and home equity financing, as well as consumer, automobile, and home improvement loans.

*Commercial Banking.* We offer a range of deposit and lending services to business customers. More specifically, we offer a variety of commercial loans for virtually any business, professional, or agricultural need. These include loans for short-term working capital, operating lines of credit, equipment purchases, leasehold improvements, construction, commercial real estate acquisitions or refinancing. Currently, virtually all of our business relationships are with customers located in the San Joaquin, Stanislaus, Tuolumne, Inyo and Mono Counties, of California.

**Primary Market Area**

We conduct business from our main office in Oakdale, a city of approximately 20,900 residents located in Stanislaus County, California. Oakdale is approximately 15 miles from Modesto and sits at the foothills of the Sierra Nevada Mountains, at the edge of the California Central Valley agricultural area. Through our branches, we serve customers in the Central Valley, from Fresno to Sacramento, and in foothill locations. We also reach into the Highway 395 corridor in the Eastern Sierras and in the towns of Bishop, Mammoth and Bridgeport. Approximately 93% of our loans and 89% of our deposits are generated from the Central Valley. The Central Valley area includes Stanislaus, San Joaquin and Tuolumne counties and has a total population of over 3 million.

**Lending Activities**

*General.* Our loan policies set forth the basic guidelines and procedures by which we conduct our lending operations. These policies address the types of loans available, underwriting and collateral requirements, loan terms, interest rate and yield considerations, compliance with laws and regulations and our internal lending limits. Our Board of Directors reviews and approves our loan policies on an annual basis. We supplement our own supervision of the loan underwriting and approval process with periodic loan audits by experienced external loan specialists who review credit quality, loan documentation and compliance with laws and regulations. We engage in a full complement of lending activities, including:

- commercial real estate loans,

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- commercial business lending and trade finance,
- Small Business Administration lending, and
- consumer loans, including automobile loans, home mortgages, credit lines and other personal loans.

As part of our efforts to achieve long-term stable profitability and respond to a changing economic environment in the California Central Valley, we constantly evaluate a variety of options to augment our traditional focus by broadening the services and products we provide. Possible avenues of growth include more branch locations, expanded days and hours of operation and new types of lending.

*Loan Procedures.* Loan applications may be approved by the Director Loan Committee of our Board of Directors, or by our management or lending officers, to the extent of their loan authority. Our Board of Directors authorizes our lending limits. Our President and Chief Credit Officer are responsible for evaluating the authority limits for individual credit officers and recommending lending limits for all other officers to the board of directors for approval.

We grant individual lending authority to our Chief Executive Officer, President, Chief Credit Officer, Credit Administrator and to some department managers and loan officers. Our highest management lending authority is combined administrative lending authority for unsecured and secured lending of \$2,500,000, which requires the approval of our Chief Executive Officer, President, and either our Chief Credit Officer or our Credit Administrator. Loans for which direct and indirect borrower liability exceeds combined administrative lending authority or 75% of the banks legal unsecured and secured lending limits are referred to our Board of Directors Loan Committee.



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At December 31, 2012, the Bank's authorized legal lending limits were \$11.2 million for unsecured loans plus an additional \$7.5 million for specific secured loans. Legal lending limits are calculated in conformance with California law, which prohibits a bank from lending to any one individual or entity or its related interests an aggregate amount which exceeds 15% of primary capital plus the allowance for loan losses on an unsecured basis, plus an additional 10% on a secured basis. The Bank's primary capital plus allowance for loan losses at December 31, 2012 totaled \$74.7 million.

We seek to mitigate the risks inherent in our loan portfolio by adhering to certain underwriting practices. The review of each loan application includes analysis of the applicant's prior credit history, income level, cash flow and financial condition, tax returns, cash flow projections, and the value of any collateral to secure the loan, based upon reports of independent appraisers and audits of accounts receivable or inventory pledged as security. In the case of real estate loans over a specified amount, the review of collateral value includes an appraisal report prepared by an independent, Bank-approved, appraiser.

*Real Estate Loans.* We offer commercial real estate loans to finance the acquisition of new or the refinancing of existing commercial properties, such as office buildings, industrial buildings, warehouses, hotels, shopping centers, automotive industry facilities and multiple dwellings. At December 31, 2012, real estate loans constituted 87% of our loan portfolio, of which 92% were commercial loans.

Commercial real estate loans typically have 10-year maturities with up to 25-year amortization of principal and interest and loan-to-value ratios of not more than 75% of the appraised value or purchase price, whichever is lower. We usually impose a prepayment penalty during the period within 3 to 5 years of the date of the loan.

Construction loans are comprised of loans on commercial, residential and income producing properties that generally have terms of 1 year, with options to extend for additional periods to complete construction and to accommodate the lease-up period. We usually require 15% equity capital investment by the developer and loan to value ratios of not more than 75% of anticipated completion value.

Miniperm loans finance the purchase and/or ownership of commercial properties, including owner-occupied and income producing properties. We also offer miniperm loans as take-out financing with our construction loans. Miniperm loans are generally made with an amortization schedule ranging from 20 to 25 years, with a lump sum balloon payment due in 3 to 5 years.

Equity lines of credit are revolving lines of credit collateralized by junior deeds of trust on residential real properties. They generally bear a rate of interest that floats with our base rate or the prime rate, and have maturities of 10 years.

We purchase participation interests in loans made by other financial institutions from time to time. These loans are subject to the same underwriting criteria and approval process as loans made directly by us.

Our real estate loans are typically collateralized by first or junior deeds of trust on specific commercial properties and equity lines of credit, and are subject to corporate or individual guarantees from financially capable parties, as available. The properties collateralizing real estate loans are principally located in our primary market areas of the California Central Valley and the Eastern Sierra. Real estate loans typically bear an

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interest rate that floats with our base rate, prime rate or another established index.

Our real estate portfolio is subject to certain risks, including (i) downturns in the California economy, (ii) interest rate increases, (iii) reduction in real estate values in the California Central Valley, (iv) increased competition in pricing and loan structure, and (v) environmental risks, including natural disasters. As a result of the high concentration of the real estate loan in our loan portfolio, the current difficulties in the real estate markets could cause significant increases in nonperforming loans, which would reduce our profits. A decline in real estate values could cause some of our mortgage loans to become inadequately collateralized, which would expose us to a greater risk of loss. Additionally, a decline in real estate values could adversely affect our portfolio of commercial real estate loans and could result in a decline in the origination of such loans. However, we strive to reduce the exposure to such risks and seek to continue to maintain high quality in our real estate loans by (a) reviewing each loan request and each loan renewal individually, (b) using a dual signature approval system for the approval of each loan request for loans over a certain dollar amount, (c) adhering to written loan policies, including, among other factors, minimum collateral requirements, maximum loan-to-value ratio requirements, cash flow requirements and personal guarantees, (d) performing secondary appraisals from time to time, (e) conducting external independent credit review, and (f) conducting environmental reviews, where appropriate. We review each loan request on the basis of our ability to recover both principal and interest in view of the inherent risks. We monitor and stress test our entire portfolio, evaluating debt coverage ratios and loan-to-value ratios, on a quarterly basis. We monitor trends and evaluate exposure derived from simulated stressed market conditions. The portfolio is stratified by owner classification (either owner occupied or non-owner occupied), product type, geography and size.

As of December 31, 2012, the aggregate loan-to-value of the entire commercial real estate portfolio was 52.4%. Historical data suggests that the Company continues to maintain strong LTV, which has served as a cushion against precipitous reductions in real

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estate values. Non-owner occupied real estate comprises 47.9% of the Company's total commitments, as of December 31, 2012. The loan-to-value on the non-owner occupied segment was 47.5%, as of December 31, 2012. The highest concentration by product type is office buildings, which comprised 29.6% of total CRE loan commitments outstanding, as of December 31, 2012.

Our portfolio diversity in terms of both product types and geographic distribution, combined with strong debt coverage ratios, a low aggregate loan-to-value and a high percentage of owner-occupied properties, significantly mitigate the risks associated with excessive commercial real estate concentration. These elements contribute strength to our overall real estate portfolio despite the current weakness in the real estate market.

*Commercial Business Lending.* We offer commercial loans to sole proprietorships, partnerships and corporations, with an emphasis on the real estate related industry. These commercial loans include business lines of credit and commercial term loans to finance operations, to provide working capital or for specific purposes, such as to finance the purchase of assets, equipment or inventory. Since a borrower's cash flow from operations is generally the primary source of repayment, our policies provide specific guidelines regarding required debt coverage and other important financial ratios.

Lines of credit are extended to businesses or individuals based on the financial strength and integrity of the borrower and are secured primarily by real estate, accounts receivable and inventory, and have a maturity of one year or less. Such lines of credit bear an interest rate that floats with our base rate, the prime rate, LIBOR or another established index.

Commercial term loans are typically made to finance the acquisition of fixed assets, refinance short-term debts or to finance the purchase of businesses. Commercial term loans generally have terms from one to five years. They may be collateralized by the asset being acquired or other available assets and bear interest rates, which either floats with the Company's base rate, prime rate, LIBOR or another established index or is fixed for the term of the loan.

We also provide other banking services tailored to the small business market. We have focused recently on diversifying our loan portfolio, which has led to an increase in commercial real estate and commercial business loans to small and medium sized businesses.

Our portfolio of commercial loans is also subject to certain risks, including (i) downturns in the California economy, (ii) interest rate increases; and (iii) the deterioration of a borrower's or guarantor's financial capabilities. We attempt to reduce the exposure to such risks through (a) reviewing each loan request and renewal individually, (b) requiring a dual signature approval system, (c) mandating strict adherence to written loan policies, and (d) performing external independent credit review. In addition, we monitor loans based on short-term asset values on a monthly or quarterly basis. In general, during the term of the relationship, we receive and review the financial statements of our borrowing customers on an ongoing basis, and we promptly respond to any deterioration that we note.

*Small Business Administration Lending Services.* Small Business Administration, or SBA, lending, forms an important part of our business. Our SBA lending service places an emphasis on minority-owned businesses. Our SBA market area includes the geographic areas encompassed by our full-service banking offices in the California Central Valley and in the Eastern Sierra. Our SBA Loan Department has attained Preferred Lender status, which permits us to approve SBA guaranteed loans directly. As an SBA Preferred Lender, we provide quicker and more efficient service to our clientele, enabling them to obtain SBA loans in order to acquire new businesses, expand existing businesses, and acquire locations in which to do business, without having to go through the time consuming SBA approval process.

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Although our participation in the SBA program is subject to the legislative power of Congress and the continued maintenance of our approved status by the SBA, we have no reason to believe that this program (and our participation therein) will not continue, particularly in view of the lengthy duration of the SBA program nationally.

*Consumer Loans.* Consumer loans include personal loans, auto loans, home improvement loans, home mortgage loans, revolving lines of credit and other loans typically made by banks to individual borrowers. We provide consumer loan products in an effort to diversify our product line.

Our consumer loan portfolio is subject to certain risks, including:

- amount of credit offered to consumers in the market,
- interest rate increases, and
- consumer bankruptcy laws which allow consumers to discharge certain debts.

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We attempt to reduce the exposure to such risks through the direct approval of all consumer loans by:

- reviewing each loan request and renewal individually,
- using a dual signature system of approval,
- strictly adhering to written credit policies and,
- performing external independent credit review.

**Deposit Activities and Other Sources of Funds**

Our primary sources of funds are deposits and loan repayments. Scheduled loan repayments are a relatively stable source of funds, whereas deposit inflows, outflows and unscheduled loan prepayments (which are influenced significantly by general interest rate levels, interest rates available on other investments, competition, economic conditions and other factors) are not as stable. Customer deposits also remain a primary source of funds, but these balances may be influenced by adverse market changes in the industry. We may resort to other borrowings, on an as needed basis, as follows:

- on a short-term basis to compensate for reductions in deposit inflows at less than projected levels, and
- on a longer-term basis to support expanded lending activities and to match the maturity of repricing intervals of assets.

We offer a variety of accounts for depositors, which are designed to attract both short-term and long-term deposits. These accounts include certificates of deposit, or CDs, regular savings accounts, money market accounts, checking and negotiable order of withdrawal, or NOW, accounts, savings accounts, health savings accounts and individual retirement accounts, or IRAs. These accounts generally earn interest at rates established by management based on competitive market factors and management's desire to increase or decrease certain types or maturities of deposits. As needs arise, we augment these customer deposits with brokered deposits. The more significant deposit accounts offered by us are described below:

*Certificates of Deposit.* We offer several types of CDs with a maximum maturity of five years. The substantial majority of our CDs have a maturity of one to twelve months and pay compounded interest typically credited monthly or at maturity.

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*Regular Savings Accounts.* We offer savings accounts that allow for unlimited ATM and in-branch deposits and withdrawals. Interest is compounded daily and paid monthly.

*Money Market Account.* Money market accounts pay a variable interest rate that is tiered depending on the balance maintained in the account. Minimum opening balances vary. Interest is compounded daily and paid monthly.

*Checking and NOW Accounts.* Checking and NOW accounts are generally non-interest and interest bearing accounts, respectively, and may include service fees based on activity and balances. NOW accounts pay interest, but require a higher minimum balance to avoid service charges.

*Federal Home Loan Bank Borrowings.* To supplement our deposits as a source of funds for lending or investment, we borrow funds in the form of advances from the Federal Home Loan Bank. We regularly make use of Federal Home Loan Bank advances as part of our interest rate risk management, primarily to extend the duration of funding to match the longer term fixed rate loans held in the loan portfolio as part of our growth strategy.

As a member of the Federal Home Loan Bank system, we are required to invest in Federal Home Loan Bank stock based on a predetermined formula. Federal Home Loan Bank stock is a restricted investment security that can only be sold to other Federal Home Loan Bank members or redeemed by the Federal Home Loan Bank. As of December 31, 2012, we owned \$2,371,600 in FHLB stock.

Advances from the Federal Home Loan Bank are typically secured by our entire real estate loan portfolio, which includes residential and commercial loans. At December 31, 2012, our borrowing limit with the Federal Home Loan Bank was approximately \$163 million.

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**Internet Banking**

Since August 1, 2001, we have offered Internet banking service, which allows our customers to access their deposit accounts through the Internet. Customers are able to obtain transaction history and account information, transfer funds between accounts and make on-line bill payments. We intend to improve and develop our Internet banking products and delivery channels as the need arises and our resources permit.

**Other Services**

We also offer ATMs located at branch offices as well as seven other ATMs at various off site locations, and customer access to an ATM network.

**Marketing**

Our marketing relies principally upon local advertising and promotional activity and upon personal contacts by our directors, officers and shareholders to attract business and to acquaint potential customers with our personalized services. We emphasize a high degree of personalized client service in order to be able to provide for each customer's banking needs. Our marketing approach emphasizes the advantages of dealing with an independent, locally managed and state chartered bank to meet the particular needs of consumers, professionals and business customers in the community. Our management continually evaluates all of our banking services with regard to their profitability and efforts and makes determinations based on these evaluations whether to continue or modify our business plan, where appropriate.

We do not currently have any plans to develop any new lines of business, which would require a material amount of capital investment on our part.

**Competition**

*Regional Branch Competition.* We consider our primary service area to be composed of the counties of San Joaquin, Stanislaus, Tuolumne, Inyo and Mono Counties, of California. The banking business in California generally, and in our primary service area, specifically, is competitive with respect to both loans and deposits and is dominated by a relatively small number of major banks which have many offices operating over wide geographic areas. These include Wells Fargo Bank, Bank of America, JP Morgan Chase Bank and Bank of the West. We compete for deposits and loans principally with these banks, as well as with savings and loan associations, thrift and loan associations, credit unions, mortgage companies, insurance companies, offerors of money market accounts and other lending institutions.

Among the advantages of these institutions are their ability to finance extensive advertising campaigns and to allocate their investment assets to regions of highest yield and demand, their ability to offer certain services, such as international banking and trust services which are not offered

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directly by the Company and, the ability by virtue of their greater total capitalization, to have substantially higher lending limits than we do. In addition, as a result of increased consolidation and the passage of interstate banking legislation there is and will continue to be increased competition among banks, savings and loan associations and credit unions for the deposit and loan business of individuals and businesses.

As of June 30, 2012, our primary service areas contained one hundred seventy-four (174) banking offices, with approximately \$11.0 billion in total deposits. As of June 30, 2012, we had total deposits of approximately \$526 million, which represented approximately 4.8% of the total deposits in the Bank's primary service area. There can be no assurance that the Bank will maintain its competitive position against current and potential competitors, especially those with greater resources than the Bank. The deposits of the four (4) largest competing banks averaged approximately \$101 million per office as of June 30, 2012.

In order to compete with major financial institutions in our primary service areas, we use to the fullest extent the flexibility that our independent status permits. This includes an emphasis on specialized services, local promotional activity, and personal contacts by our officers, directors and employees. In the event that there are customers whose needs exceed our lending limits, we may arrange for such loans on a participation basis with other financial institutions. We also assist customers who require other services that we do not offer by obtaining such services from correspondent banks. However, no assurance can be given that our continued efforts to compete with other financial institutions will be successful.

In addition to other banks, our competitors include savings institutions, credit unions, and numerous non-banking institutions, such as finance companies, leasing companies, insurance companies, brokerage firms, and investment banking firms. In recent years, increased competition has also developed from specialized finance and non-finance companies that offer money market and mutual funds, wholesale finance, credit card, and other consumer finance services, including on-line banking services and personal finance



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software. Strong competition for deposit and loan products affects the rates of those products as well as the terms on which they are offered to customers.

*Other Competitive Factors.* The more general competitive trends in the industry include increased consolidation and competition. Strong competitors, other than financial institutions, have entered banking markets with focused products targeted at highly profitable customer segments. Many of these competitors are able to compete across geographic boundaries and provide customers increasing access to meaningful alternatives to banking services in nearly all significant products areas. Mergers between financial institutions have placed additional pressure on banks within the industry to streamline their operations, reduce expenses, and increase revenues to remain competitive. Competition has also intensified due to the federal and state interstate banking laws, which permit banking organizations to expand geographically, and the California market has been particularly attractive to out-of-state institutions. The Financial Modernization Act, which has made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies, is also expected to intensify competitive conditions.

Technological innovations have also resulted in increased competition in the financial services industry. Such innovations have, for example, made it possible for non-depository institutions to offer customers automated transfer payment services that were previously considered traditional banking products. In addition, many customers now expect a choice of several delivery systems and channels, including telephone, mail, home computer, ATMs, self-service branches and/or in-store branches.

*Business Concentration.* No individual or single group of related accounts is considered material in relation to our total assets or deposits, or in relation to our overall business. However, approximately 87% of our loan portfolio held for investment at December 31, 2012 consisted of real estate-related loans, including construction loans, miniperm loans, real estate mortgage loans and commercial loans secured by real estate. Moreover, our business activities are currently focused primarily in Central California, with the majority of our business concentrated in San Joaquin, Stanislaus, Tuolumne, Inyo and Mono Counties. Consequently, our results of operations and financial condition are dependent upon the general trends in the Central California economies and, in particular, the residential and commercial real estate markets. In addition, the concentration of our operations in Central California exposes us to greater risk than other banking companies with a wider geographic base in the event of catastrophes, such as earthquakes, fires and floods in this region.

## **Employees**

As of December 31, 2012, we had 139 employees (111 full-time employees and 28 part-time employees). None of our employees are currently represented by a union or covered by a collective bargaining agreement.

## **Bank Holding Company Regulation**

Upon effectiveness of the bank holding company reorganization on July 2, 2008, we became subject to regulation under the Bank Holding Company Act of 1956, as amended ( BHCA ) which subjects Oak Valley Bancorp to Federal Reserve Board reporting and examination requirements. Under the Federal Reserve Board's regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks.

The BHCA regulates the activities of holding companies including acquisitions, mergers, and consolidations and, together with the Gramm-Leach Bliley Act of 1999, the scope of allowable banking activities.

### **Bank Regulation**

The banking and financial services business in which we engage is highly regulated. Such regulation is intended, among other things, to protect depositors insured by the FDIC and the entire banking system. These regulations affect our lending practices, consumer protections, capital structure, investment practices and dividend policy.

As a state chartered bank, we are subject to regulation and examination by the DFI. We are also subject to regulation, supervision and periodic examination by the FDIC. If, as a result of an examination of the Bank, the FDIC or the DFI should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of our operations are unsatisfactory, or that we have violated any law or regulation, various remedies are available to those regulators including issuing a consent order, restricting our growth or removing officers and directors.

The commercial banking business is also influenced by the monetary and fiscal policies of the federal government and the policies of the Board of Governors of the Federal Reserve System, also known as the FRB. As a member of the Federal Reserve System, we are subject to certain regulations of the Board of Governors of the Federal Reserve System. The regulations of these agencies govern most aspects of our business, including the filing of periodic reports, and activities relating to dividends, investments,

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loans, borrowings, capital requirements, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits, and numerous other areas. Supervision, legal action and examination of us by the FRB is generally intended to protect depositors and is not intended for the protection of our shareholders. The Federal Reserve Board implements national monetary policies (with objectives such as curbing inflation and combating recession) by its open-market operations in United States Government securities, by adjusting the required level of reserves for financial intermediaries subject to its reserve requirements and by varying the discount rates applicable to borrowings by depository institutions. The actions of the Federal Reserve Board in these areas influence the growth of bank loans, investments and deposits and affects interest rates charged on loans and paid on deposits. Indirectly such actions may also impact the ability of non-bank financial institutions to compete with us. The nature and impact of any future changes in monetary policies cannot be predicted.

The laws, regulations and policies affecting financial services businesses are continuously under review by Congress and state legislatures and federal and state regulatory agencies. From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial intermediaries. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies and other financial intermediaries are frequently made in Congress, in the California legislature and by various bank regulatory agencies and other professional agencies. Changes in the laws, regulations or policies that impact us cannot necessarily be predicted, but they may have a material effect on our business and earnings.

The following discussion summarizes certain significant laws, rules and regulations affecting both the Company and the Bank. The Bank addresses the many state and federal regulations it is subject to through a comprehensive compliance program that addresses the various risks associated with these issues. The following discussion is not meant to cover all applicable rules and regulations and it is qualified in its entirety by reference to such laws, rules and regulations which may change from time to time.

### **Capital Adequacy Requirements**

The federal banking agencies have adopted risk-based minimum capital guidelines intended to provide a measure of capital that reflects the degree of risk associated with a banking organization's operations for both transactions reported on the balance sheet as assets and transactions which are recorded as off balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as federal banking agencies, to 100% for assets with relatively high credit risk. The higher the category, the more risk a bank is subject to and thus the more capital that is required.

The guidelines divide a bank's capital into two tiers. Tier I includes common equity, retained earnings, certain non-cumulative perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries. Goodwill and other intangible assets (except for mortgage servicing rights and purchased credit card relationships, subject to certain limitations) are subtracted from Tier I capital. Tier II capital includes, among other items, cumulative perpetual and long-term, limited-life preferred stock, mandatory convertible securities, certain hybrid capital instruments, term subordinated debt and the allowance for loan losses (subject to certain limitations). Certain items are required to be deducted from Tier II capital. Banks must maintain a total risk-based ratio of 8%, of which at least 4% must be Tier I capital. As of December 31, 2012 and 2011, the Bank's Total Risk-Based Capital Ratio was 16.0% and 16.2%, and our Tier 1 Risk-Based Capital Ratio was 14.8% and 14.9%, respectively.

In addition to the risk-based guidelines, federal banking regulators require banking organizations to maintain a minimum amount of Tier 1 capital to total average assets, referred to as the leverage ratio. Banks that have received the highest rating of the five categories used by regulators to rate banks and are not anticipating or experiencing any significant growth must maintain a ratio of Tier 1 capital (net of all

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intangibles) to adjusted total assets, or Leverage Capital Ratio, of at least 3%. All other institutions are required to maintain a leverage ratio of at least 100 to 200 basis points above the 3% minimum, for a minimum of 4% to 5%. Pursuant to federal regulations, banks must maintain capital levels commensurate with the level of risk to which they are exposed, including the volume and severity of problem loans. As of December 31, 2012 and 2011, the Bank's Leverage Capital Ratios were 10.3% and 11.4%, respectively.

Federal banking regulators may set capital requirements higher than the minimums described above for financial institutions whose circumstances warrant it. For example, a financial institution experiencing or anticipating significant growth may be expected to maintain capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets.

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**Prompt Corrective Action Provisions**

Federal law requires each federal banking agency to take prompt corrective action to resolve the problems of insured financial institutions, including but not limited to those that fall below one or more prescribed minimum capital ratios. The federal banking agencies have by regulation defined the following five capital categories:

- well capitalized (Total Risk-Based Capital Ratio of 10%; Tier 1 Risk-Based Capital Ratio of 6%; and Leverage Ratio of 5%),
- adequately capitalized (Total Risk-Based Capital Ratio of 8%; Tier 1 Risk-Based Capital Ratio of 4%; and Leverage Ratio of 4% or 3% if the institution receives the highest rating from its primary regulator),
- undercapitalized (Total Risk-Based Capital Ratio of less than 8%; Tier 1 Risk-Based Capital Ratio of less than 4%; or Leverage Ratio of less than 4% or 3% if the institution receives the highest rating from its primary regulator),
- significantly undercapitalized (Total Risk-Based Capital Ratio of less than 6%; Tier 1 Risk-Based Capital Ratio of less than 3%; or Leverage Ratio less than 3%), and
- critically undercapitalized (tangible equity to total assets less than 2%).

The Bank is well capitalized.

A bank may be treated as though it were in the next lower capital category if, after notice and the opportunity for a hearing, the appropriate federal agency finds an unsafe or unsound condition or practice so warrants, but no bank may be treated as critically undercapitalized unless its actual capital ratio warrants such treatment.

At each successively lower capital category, an insured bank is subject to increased restrictions on its operations. For example, a bank is generally prohibited from paying management fees to any controlling persons or from making capital distributions, if to do so would make the Bank undercapitalized. Asset growth and branching restrictions apply to undercapitalized banks, which are required to submit written capital restoration plans meeting specified requirements (including a guarantee by the parent holding company, if any). Significantly undercapitalized banks are subject to broad regulatory authority, including among other things, capital directives, forced mergers, restrictions on the rates of interest they may pay on deposits, restrictions on asset growth and activities, and prohibitions on paying certain bonuses without FRB approval. Even more severe restrictions apply to critically undercapitalized banks. Most importantly, except under limited circumstances, the appropriate federal banking agency is required to appoint a conservator or receiver for an insured bank not later than 90 days after the Bank becomes critically undercapitalized.

In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential actions by federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the issuance of cease and desist orders, termination of insurance of deposits (in the case of a bank), the imposition of civil money penalties, the issuance of directives to increase capital, formal and informal agreements, or removal and prohibition orders against institution-affiliated parties.

### **Dividends**

The payment of cash dividends by the Bank to Oak Valley Bancorp is subject to restrictions set forth in the California Financial Code (the Code ). Prior to any distribution from the Bank to Oak Valley Bancorp, a calculation is made to ensure compliance with the provisions of the Code and to ensure that the Bank remains within capital guidelines set forth by the DFI and the FRB. In the event that the intended distribution from the Bank to Oak Valley Bancorp exceeds the restriction in the Code, advance approval from FRB is required. While advance approval may be required from the FRB for up to three years after we terminated our participation in the U.S. Treasury Capital Purchase Program in 2011, management does not believe that these regulations will limit dividends from the Bank to meet the operating requirements of Bancorp for the foreseeable future. See Note 20 to the Consolidated Financial Statements in Item 8 of this report. Management anticipates that there will be sufficient earnings at the Bank level to provide dividends to the Company to meet its cash requirements for 2013.

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**Safety and Soundness Standards**

Federal banking agencies have also adopted guidelines establishing safety and soundness standards for all insured depository institutions. Those guidelines relate to internal controls, information systems, internal audit systems, loan underwriting and documentation, compensation and interest rate exposure. In general, the standards are designed to assist the federal banking agencies in identifying and addressing problems at insured depository institutions before capital becomes impaired. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan and institute enforcement proceedings, if an acceptable compliance plan is not submitted.

**Deposit Insurance and FDIC Insurance Assessments**

Our deposits are insured by the FDIC to the maximum amount permitted by law, which is currently \$250,000 per depositor. The 2010 enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) made the deposit insurance coverage permanent at the \$250,000 level retroactive to January 1, 2008.

On February 7, 2011, as required by the Dodd-Frank Act, the FDIC approved a rule that changes the FDIC insurance assessment base from adjusted domestic deposits to a bank's average consolidated total assets minus average tangible equity, defined as Tier 1 capital. Since the new base is larger than the current base, the new rule lowers assessment rates to between 2.5 and 9 basis points on the broader base for banks in the lowest risk category, and 30 to 45 basis points for banks in the highest risk category. The change was effective beginning with the second quarter of 2011. Since we have a solid core deposit base and do not rely heavily on borrowings and brokered deposits, the benefit of the lower assessment rate (which has dropped by approximately half for us) significantly outweighed the effect of a wider assessment base.

The Dodd-Frank act also provided depositors at all FDIC-insured institutions with unlimited deposit insurance coverage on traditional checking accounts that do not pay interest and Interest on Lawyers Trust Accounts beginning December 31, 2010 through the end of 2012, when this provision expired.

During 2009 and 2010, we elected to participate in the Temporary Transaction Account Guarantee Program, which provided full deposit insurance coverage to non-interest bearing transaction accounts (including low-interest negotiable order of withdrawal accounts and interest on lawyer trust accounts), by paying a 10 basis point surcharge on the non-interest bearing transaction accounts over \$250,000 through December 31, 2009, and a 15 basis point surcharge through December 31, 2010, when the program ended.

On November 12, 2009, the FDIC finalized a Deposit Insurance Fund restoration plan that required banks to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. Under the plan, banks were assessed through 2010 according to the risk-based premium schedule adopted in April 2009.

**Community Reinvestment Act**

We are subject to certain requirements and reporting obligations involving the Community Reinvestment Act, or CRA. The CRA generally requires federal banking agencies to evaluate the record of financial institutions in meeting the credit needs of local communities, including low and moderate-income neighborhoods. The CRA further requires that a record be kept of whether a financial institution meets its community credit needs, which record will be taken into account when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions, or holding company formations. In measuring a bank's compliance with its CRA obligations, the regulators now utilize a performance-based evaluation system, which bases CRA ratings on the Company's actual lending service and investment performance, rather than on the extent to which the institution conducts needs assessments, documents community outreach activities or complies with other procedural requirements. In connection with its assessment of CRA performance, the FRB assigns a rating of outstanding, satisfactory, needs to improve or substantial noncompliance. Our CRA performance is evaluated by the FRB under the intermediate small bank requirements. The FRB's last CRA performance examination was performed on us and completed in July of 2011 and we received an overall Satisfactory CRA Assessment Rating.

### **Anti-Money Laundering Regulations**

A series of banking laws and regulations beginning with the Bank Secrecy Act in 1970 require banks to prevent, detect, and report illicit or illegal financial activities to the federal government to prevent money laundering, international drug trafficking, and terrorism. Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct



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Terrorism Act of 2001, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and know your customer standards in their dealings with high risk customers, foreign financial institutions, and foreign individuals and entities. We have extensive controls to comply with these requirements.

**Privacy and Data Security**

The Gramm-Leach Bliley Act ( GLBA ) of 1999 imposed requirements on financial institutions with respect to consumer privacy. The GLBA generally prohibits disclosure of consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to consumers annually. The GLBA also directs federal regulators to prescribe standards for the security of consumer information. We are subject to such standards, as well as standards for notifying consumers in the event of a security breach. We must disclose our privacy policy to consumers and permit consumers to opt out of having non-public customer information disclosed to third parties. We are required to have an information security program to safeguard the confidentiality and security of customer information and to ensure proper disposal. Customers must be notified when unauthorized disclosure involves sensitive customer information that may be misused.

**Other Consumer Protection Laws and Regulations**

Bank regulatory agencies are increasingly focusing on compliance with consumer protection laws and regulations. Examination and enforcement has become intense, and banks have been advised to monitor compliance carefully with various consumer protection laws and their implementing regulations. For example, the federal Interagency Task Force on Fair Lending issued a policy statement on discrimination in home mortgage lending describing three methods that federal agencies will use to prove discrimination: overt evidence of discrimination, evidence of disparate treatment, and evidence of disparate impact. In addition to CRA and fair lending requirements, we are subject to numerous other federal consumer protection statutes and regulations. Due to heightened regulatory concern related to compliance with consumer protection laws and regulations generally, we may incur additional compliance costs or be required to expend additional funds for investments in the local communities we serve.

**Restriction on Transactions between Member Banks and their Affiliates**

Transactions between the Company and the Bank are quantitatively and qualitatively restricted under Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. Section 23A places restrictions on the Bank's covered transactions with the Company, including loans and other extensions of credit, investments in the securities of, and purchases of assets from the Company. Section 23B requires that certain transactions, including all covered transactions, be on market terms and conditions. Federal Reserve Regulation W combines statutory restrictions on transactions between the Bank and the Company with FRB interpretations in an effort to simplify compliance with Sections 23A and 23B.

**The Sarbanes-Oxley Act of 2002**

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On July 30, 2002, President Bush signed into law The Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley Act . The Sarbanes-Oxley Act addresses accounting oversight and corporate governance matters relating to the operations of public companies. During 2003, the Commission issued a number of regulations under the directive of the Sarbanes-Oxley Act significantly increasing public company governance-related obligations and filing requirements, including:

- the establishment of an independent public oversight of public company accounting firms by a board that will set auditing, quality and ethical standards for and have investigative and disciplinary powers over such accounting firms,
- the enhanced regulation of the independence, responsibilities and conduct of accounting firms which provide auditing services to public companies,
- the increase of penalties for fraud related crimes,
- the enhanced disclosure, certification, and monitoring of financial statements, internal financial controls and the audit process, and
- the enhanced and accelerated reporting of corporate disclosures and internal governance.

Furthermore, in November 2003, in response to the directives of the Sarbanes-Oxley Act, Nasdaq adopted substantially expanded corporate governance criteria for the issuers of securities quoted on the Nasdaq markets. The new Nasdaq rules govern, among other

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things, the enhancement and regulation of corporate disclosure and internal governance of listed companies and of the authority, role and responsibilities of their boards of directors and, in particular, of independent members of such boards of directors, in the areas of nominations, corporate governance, compensation and the monitoring of the audit and internal financial control processes.

The Sarbanes-Oxley Act, the Commission rules promulgated thereunder, and the new Nasdaq governance requirements have required the Company to review its current procedures and policies to determine whether they comply with the new legislation and its implementing regulations. Oak Valley Bancorp is primarily responsible for ensuring compliance with Sarbanes-Oxley and the Nasdaq governance rules, as applicable.

**Emergency Economic Stabilization Act of 2009**

Dramatic negative developments in the latter half of 2007 in the subprime mortgage market and the securitization markets for such loans, together with volatility in oil prices and other factors, have resulted in uncertainty in the financial markets in general and a related economic downturn, which effects continued to be felt among financial institutions through 2012.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 ( EESA ) was enacted to restore confidence and stabilize the volatility in the U.S. banking system and to encourage financial institutions to increase their lending to customers and to each other. Through a program initially known as the Treasury Capital Purchase Program ( TCPP ) that was carved out of the Troubled Asset Relief Program ( TARP ), the EESA authorized the United States Department of the Treasury ( U.S. Treasury ) to purchase from financial institutions and their holding companies up to \$700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions and their holding companies. Initially, \$350 billion was made immediately available to the U.S. Treasury. On January 15, 2009, the remaining \$350 billion was released to the U.S. Treasury.

Consistent with its prudent approach and attention to liquidity during a time of general market turmoil and severe limitations in accessing the capital markets, in December 2008 the Company participated in the TCPP and issued \$13.5 million of preferred stock to the U.S. Treasury, together with a warrant to acquire 350,346 shares of common stock. Both the preferred stock and the warrant have been repurchased by the Company. However, during the period when the Company participated in the TCPP, we were subject to restrictions on executive compensation and limitations on dividends and stock repurchases, with which we complied with. The compensation restrictions generally applied to the Chief Executive Officer, Chief Financial Officer and the three next most highly compensated senior executive officers.

**The American Recovery and Reinvestment Act of 2009**

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 ( ARRA ) was signed into law by President Obama. The ARRA includes a wide variety of programs intended to stimulate the economy and provide for extensive infrastructure, energy, health, and education needs. In addition, the ARRA imposes certain new executive compensation and corporate expenditure limits on all current and future TCPP recipients, including the Company, until the institution has repaid the U.S. Treasury, which is now permitted under the ARRA without penalty and without the need to raise new capital, subject to the U.S. Treasury's consultation with the recipient's appropriate regulatory agency.

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The ARRA executive compensation standards that went into effect on September 14, 2009 were more stringent than those in effect under the TCPP. The ARRA standards include (but are not limited to); (i) prohibitions on bonuses, retention awards and other incentive compensation, other than restricted stock grants which do not fully vest during the TCPP period up to one-third of an employee's total annual compensation, (ii) prohibitions on golden parachute payments for departures, (iii) an expanded clawback of bonuses, retention awards, and incentive compensation if payment is based on materially inaccurate statements of earnings, revenues, gains or other criteria, (iv) prohibitions on compensation plans that encourage manipulation of reported earnings, (v) retroactive review of bonuses, retention awards and other compensation previously provided by TCPP recipients if found by the U.S. Treasury to be inconsistent with the purposes of TCPP or otherwise contrary to public interest, (vi) required establishment of a company-wide policy regarding excessive or luxury expenditures, and (vii) inclusion in a participant's proxy statements for annual shareholder meetings of a nonbinding Say on Pay shareholder vote on the compensation of executives.

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**The Dodd-Frank Wall Street Reform and Consumer Protection Act**

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ( Act ), a landmark financial reform bill comprised of massive volume of new rules and restrictions that will impact banks going forward. It includes key provisions aimed at preventing a repeat of the 2008 financial crisis and a new process for winding down failing, systemically important institutions in a manner as close to a controlled bankruptcy as possible. The Act includes other key provisions as follows:

(1) The Act establishes a new Financial Stability Oversight Council to monitor systemic financial risks. The FRB is given extensive new authorities to impose strict controls on large bank holding companies with total consolidated assets equal to or in excess of \$50 billion and systemically significant nonbank financial companies to limit the risk they might pose for the economy and to other large interconnected companies. The FRB can also take direct control of troubled financial companies that are considered systemically significant.

The Act restricts the amount of trust preferred securities ( TPS ) that may be considered as Tier 1 Capital. For bank holding companies below \$15 billion in total assets, TPS issued before May 19, 2010 will be grandfathered, so their status as Tier 1 capital does not change. Beginning January 1, 2013, bank holding companies above \$15 billion in assets will have a three-year phase-in period to fill the capital gap caused by the disallowance of the TPS issued before May 19, 2010. However going forward, TPS will be disallowed as Tier 1 capital.

(2) The Act creates a new process to liquidate failed financial firms in an orderly manner, including giving the FDIC broader authority to operate or liquidate a failing financial company.

(3) The Act also establishes a new independent Federal regulatory body for consumer protection within the Federal Reserve System known as the Bureau of Consumer Financial Protection (the Bureau ), which will assume responsibility for most consumer protection laws (except the Community Reinvestment Act). It will also be in charge of setting appropriate consumer banking fees and caps. The Office of Comptroller of the Currency will continue to have authority to preempt state banking and consumer protection laws if these laws prevent or significantly interfere with the business of banking.

(4) The Act effects changes in the FDIC assessment as discussed in section FDIC Insurance Assessments above.

(5) The Act places certain limitations on investment and other activities by depository institutions, holding companies and their affiliates, including comprehensive regulation of all over-the-counter derivatives.

(6) The Act states that the FRB is authorized to regulate interchange fees on debit cards and certain general-use prepaid card transactions paid to issuing banks with assets in excess of \$10 billion to ensure that they are reasonable and proportional to the cost of processing individual transactions, and to prohibit debit and general-use prepaid payment card networks and issuers from requiring transactions to be processed on a single payment network. The FRB issued its final rule on June 29, 2011.

**Securities Laws and Corporate Governance**

The Company is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, both as administered by the SEC. As a company listed on the NASDAQ Global Select Market, the Company is subject to NASDAQ listing standards for listed companies.

As discussed above, we are also subject to the Sarbanes-Oxley Act of 2002, provisions of the Dodd-Frank Act, and other federal and state laws and regulations which address, among other issues, required executive certification of financial presentations, corporate governance requirements for board audit committees and their members, and disclosure of controls and procedures and internal control over financial reporting, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. NASDAQ has also adopted corporate governance rules, which are intended to allow shareholders and investors to more easily and efficiently monitor the performance of companies and their directors.

Finally, the Company is subject to the provisions of the California General Corporation Law, while the Bank is also subject to the California Financial Code provisions.

**Environmental Regulations**

In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury,

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investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be materially and adversely affected.

**Other Pending and Proposed Legislation**

Other legislative and regulatory initiatives which could affect us and the banking industry, in general, are pending and additional initiatives may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject us to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. We cannot predict whether, or in what form, any such legislation or regulations may be enacted or the extent to which our business would be affected thereby.

**Available Information**

The Company maintains an Internet website at <http://www.ovcb.com>. The Company makes available its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and other information related to the Company free of charge, through this site as soon as reasonably practicable after it electronically files those documents with, or otherwise furnishes them to, the SEC. The Company's website also contains a copy of our Code of Ethics. The Company's internet website and the information contained therein or connected thereto are not intended to be incorporated into this annual report on Form 10-K.

In addition, copies of our filings are available by requesting them in writing or by phone from:

Corporate Secretary

Oak Valley Bancorp

125 North Third Avenue  
Oakdale, California

209-844-7578

**ITEM 1A. RISK FACTORS**

Not applicable.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.



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Our main office is located in a complex at 125 North Third Avenue, Oakdale, CA 95361, in downtown Oakdale and houses our primary loan production, operations, and administrative offices. The building has an automated teller machine and onsite parking. The Company's complex occupies approximately 20,000 square feet of space.

| Property Location and Address     | Square Footage | Lease Expiration Date | Lease Extension Options       |
|-----------------------------------|----------------|-----------------------|-------------------------------|
| Oakdale, 125 N. 3rd Ave.          | 9,600          | n/a*                  | n/a*                          |
| Oakdale, 338 F Street             | 9,860          | 3/2017                | three, 5-year term extensions |
| Sonora, 14580 Mono Way            | 2,500          | 4/2018                | two, 5-year term extensions   |
| Modesto, 12th & I Street          | 4,500          | 3/2016                | two, 5-year term extensions   |
| Bridgeport, 166 Main Street       | 2,875          | n/a*                  | n/a*                          |
| Mammoth Lakes, 170 Mountain Blvd. | 1,856          | n/a*                  | n/a*                          |
| Bishop, 351 North Main Street     | 3,680          | 8/2014                | two, 5-year term extensions   |
| Modesto, 4120 Dale Road           | 4,500          | 3/2015                | two, 5-year term extensions   |
| Turlock, 2001 Geer Road           | 2,400          | 1/2015                | two, 5-year term extensions   |
| Patterson, 20 Plaza Circle        | 2,100          | n/a*                  | n/a*                          |
| Escalon, 1910 McHenry Ave.        | 3,500          | 4/2021                | two, 5-year term extensions   |
| Ripon, 150 North Wilma Ave.       | 1,800          | 12/2015               | one, 5-year term extension    |
| Stockton, 2935 West March Lane    | 8,000          | 12/2022               | two, 5-year term extensions   |
| Modesto, 3508 McHenry Ave.        | 5,400          | n/a*                  | n/a*                          |
| Manteca, 191 W. North St.         | 2,800          | 5/31/2016             | two, 5-year term extensions   |

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\* The Company owns this property.

Management has determined that all of its premises are adequate for its present and anticipated level of business.

**ITEM 3. LEGAL PROCEEDINGS**

From time to time, the Company is a party to claims and legal proceedings arising in the ordinary course of business. Our management evaluates its exposure to these claims and proceedings individually and in the aggregate and provides for potential losses on such litigation if the amount of the loss is estimable and the loss is probable.

To our knowledge, there are no material litigation matters pending at the current time. Although the results of any such litigation matters and claims cannot be predicted with certainty, we believe that the final outcome of any such claims and proceedings will not have a material adverse impact on the Company's financial position, liquidity, or results of operations.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.****Price Range of Common Stock**

Our common stock is traded on the NASDAQ Capital Market under the symbol OVLY. The following table sets forth the high and low closing bid prices (which reflect prices between dealers and do not include retail markup, markdown or commission and may not represent actual transactions) for the current year and the two calendar years ended December 31, 2012 and 2011, respectively. From time to time, during the periods indicated, trading activity in our common stock was infrequent. The source of the quotes is The Nasdaq Stock Market, LLC.

| For Calendar Quarter Ended | Closing Sale Price |         |
|----------------------------|--------------------|---------|
|                            | High               | Low     |
| March 31, 2011             | \$ 6.25            | \$ 5.80 |
| June 30, 2011              | \$ 6.25            | \$ 5.85 |
| September 30, 2011         | \$ 6.05            | \$ 4.05 |
| December 31, 2011          | \$ 6.99            | \$ 4.65 |
| March 31, 2012             | \$ 8.20            | \$ 5.80 |
| June 30, 2012              | \$ 7.93            | \$ 6.17 |
| September 30, 2012         | \$ 8.25            | \$ 5.02 |
| December 31, 2012          | \$ 8.15            | \$ 6.75 |

On March 19, 2013, the closing price of our common stock was \$8.04 per share; and there were approximately 482 shareholders of record of the common stock and 7,914,730 outstanding shares of common stock.

**Dividends**

Our ability to pay any cash dividends will depend not only upon our earnings during a specified period, but also on our meeting certain capital requirements.

Furthermore, the Company participated in the U.S. Treasury Small Business Lending Fund program in August 2011, pursuant to which we issued to the U.S. Treasury 13,500 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B. As of December 31, 2012, after redeeming half of the original shares in May of 2012, the Company had 6,750 shares outstanding and so long as any share of Series B Preferred Stock remains outstanding, the Company may declare and pay dividends on the common stock only if (A) after giving effect to such dividend the Company's Tier 1 capital would be at least equal to the Tier 1 Dividend Threshold (as such term is defined in Section 2(rr) of the Series B Preferred Stock Certificate of Determination, which is incorporated by reference as Exhibit 4.3) and (B) full dividends on all outstanding shares

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of Series B Preferred Stock for the most recently completed calendar quarter have been or are contemporaneously declared and paid. However, on March 13, 2013, the Company fully redeemed all the remaining 6,750 shares and, as of the current date, no shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B.

Shareholders are entitled to receive dividends only when and if dividends are declared by our Board of Directors. Although we have paid dividends in the past, it is no guarantee that we will pay cash dividends in the future. No dividends were paid for the years ended December 31, 2012 and 2011.

Table of Contents**Equity Compensation Plan Information**

The following table provides information as of December 31, 2012 with respect to shares of our common stock that are issued and currently outstanding under the Company's 1998 Restated Stock Option Plan (the "1998 Restated Stock Option Plan"), and the number of shares that are authorized to be issued under the Company's 2008 Equity Plan (the "2008 Equity Plan"). Figures in the table have been retroactively adjusted to reflect three-for-two stock splits in August 2005 and 2006.

| Plan Category  | A  | B  |             | C  |
|--|--|--|-------------|--|
|  | Number of Securities to be Issued Upon Exercise of Outstanding Options | Weighted Average Exercise Price of Outstanding Options |             | Number of Securities Remaining Available for Future Issuance Under 2008 Equity Plan (Excluding Securities Reflected in Column A) |
| Equity Compensation Plans Approved by Shareholders     | 227,187  | \$   | 9.15        | 1,349,320  |
| Equity Compensation Plans Not Approved by Shareholders | 0  |  | 0           | 0  |
| <b>Total</b>   | <b>227,187</b>   | <b>\$</b>  | <b>9.15</b> | <b>1,349,320</b>   |

**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

Not applicable.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

The following discussion of financial condition as of December 31, 2012 and 2011 and results of operations for each of the years in the two-year period ended December 31, 2012 should be read in conjunction with our consolidated financial statements and related notes thereto, included in this report. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

**Forward-Looking Statements**

This discussion of financial results includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the "1933 Act") and Section 21E of the Securities Exchange Act of 1934, as amended, (the "1934 Act"). Those sections of the 1933 Act and 1934 Act provide a "safe harbor" for forward-looking statements to encourage companies to provide prospective information about their financial performance so long as they provide meaningful, cautionary statements identifying important factors that could cause actual results to differ significantly from projected results.

Our forward-looking statements include descriptions of plans or objectives of Management for future operations, products or services, and forecasts of our revenues, earnings or other measures of economic performance. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include the words believe, expect, intend, estimate or words of similar meaning, or future or conditional verbs such as will, would, should, could or may.

Forward-looking statements are based on Management's current expectations regarding economic, legislative, and regulatory issues that may impact our earnings in future periods. A number of factors - many of which are beyond Management's control - could cause future results to vary materially from current Management's expectations. Such factors include, but are not limited to, general economic conditions, the current financial turmoil in the United States and abroad, changes in interest rates, deposit flows, real estate values and industry competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; and other economic, competitive, governmental, regulatory and technological factors affecting our operations, pricing, products and services. Forward-looking statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

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**Introduction**

Our continued focus on responsible community banking fundamentals and our strong customer relationships have enabled us to increase net income to common shareholders in 2012, and have led to higher core deposits, a key funding source for our steady asset growth.

As of December 31, 2012, we had approximately \$661 million in total assets, \$391 million in total gross loans, and \$587 million in total deposits.

We believe the following were key indicators of our performance for operations during 2012:

- our total assets increased to \$661 million at the end of 2012, an increase of 7.9%, from \$612 million at the end of 2011.
- our total deposits increased to \$587 million at the end of 2012, an increase of 9.5%, from \$536 million at the end of 2011.
- our total net loans decreased to \$382 million at the end of 2012, a decrease of 1.2%, from \$387 million at the end of 2011.
- our ratio of total non-performing loans to total loans decreased to 1.77% at December 31, 2012 from 1.83% at December 31, 2011. Management considers that the size of the ratio of non-performing assets to total loans is moderate and manageable, and reserves have been taken appropriately.
- net interest income decreased \$0.3 million or 1.3% in 2012 compared to 2011, mainly as a result of lower market interest rate on loans and investment securities.
- provision for loan losses decreased \$0.35 million or 23.3% to \$1.15 million in 2012 compared to \$1.5 million in 2011.
- total noninterest income increased to \$3.1 million in 2012, an increase of 14.5%, from \$2.8 million in 2011, which is mainly attributable to our growing deposit account base.

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- total noninterest expense increased from \$17.4 million in 2011 to \$18.2 million in 2012, reflecting the increase in overhead costs associated with two new branch openings in 2011.

These items, as well as other factors, contributed to the increase in net income available to common shareholders for 2012 to \$5.33 million from \$4.70 million in 2011, which translates into \$0.69 per diluted common share in 2012 and \$0.61 per diluted common share in 2011.

Over the past several years, our network of branches and loan production offices has been expanded geographically. We currently maintain fourteen full-service offices. We intend to continue our growth strategy in future years through the opening of additional branches and loan production offices as our needs and resources permit.

### 2013 Outlook

As we begin our strategic business plan for 2013, we are continuing to explore opportunities for growth in our existing markets, as well as opportunities to expand into new markets through *de novo* branching. In 2013, we are continuing to focus on loan and account growth and managing our net interest margin, while attempting to control expenses and credit losses and manage our business to achieve our net income and other objectives. Efforts to attract new accounts and grow loans continue to be an important strategic initiative.

As a result of market interest rates declining to historic lows in 2012, we recognized a decrease in our net interest income, which we expect could slightly compress further in 2013 even if interest rates begin to increase. The potential compression of net interest income and net interest margin would be a likely outcome if interest rates increase, given that our balance sheet is liability sensitive to interest rate changes primarily due to the number of loans currently at their contractual rate floors and competitive pressures to increase deposit rates. This could in turn result in a slower increase on the yield of earning assets compared to the cost of deposits and other funds. Ideally, if we experience an increase in our yield on earnings assets we could then determine to increase the interest rates we pay on our deposit accounts or change our promotional or other interest rates on new deposits in marketing activation programs to attempt to achieve a certain net interest margin. In light of the current economic environment, it may not be possible to manage the interest margin in this manner, as competitive pressures may dictate that we increase deposit rates at a faster rate than the earning assets increase, thereby further compressing the net interest margin. Any increases in the rates we charge on accounts could have an effect on our efforts to attract new customers and grow loans, particularly with the continuing competition in the commercial and consumer lending industry. The economies and real estate markets in our primary market areas will continue to be significant



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determinants of the quality of our assets in future periods and, thus, our results of operations, liquidity and financial condition. Current economic indicators suggest that the national economy and the economies in our primary market areas will remain depressed but the length and severity of the cycle is difficult to predict.

For 2013, management remains focused on the above challenges and opportunities and other factors affecting the business similar to the factors driving 2012 results as discussed in this section.

***Holding Company***

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

In the bank holding company reorganization, all outstanding shares of common stock of the Bank were exchanged for an equal number of shares of common stock of Oak Valley Bancorp, which now owns the Bank as its wholly-owned subsidiary. Management believes that operating the Bank within a holding company structure, among other things:

- provides greater operating flexibility than is currently enjoyed by us.
  
- facilitates the acquisition of related businesses as opportunities arise.
  
- improves our ability to diversify.
  
- enhances our ability to remain competitive in the future with other companies in the financial services industry that are organized in a holding company structure.
  
- enhances our ability to raise capital to support growth.

The financial statements and discussion thereof contained in this report for periods subsequent to the reorganization relate to the consolidated financial statements of Oak Valley Bancorp. Periods prior to the reorganization relate to the Bank only. The information is comparable as the sole subsidiary of Oak Valley Bancorp is the Bank.

### **Critical Accounting Policies**

Critical accounting policies are those that are both most important to the portrayal of our financial condition and results of operations and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that effect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions. In addition, GAAP itself may change from one previously acceptable method to another method, although the economics of our transactions would be the same.

Management has determined the following accounting policies to be critical:

### ***Asset Impairment Judgments***

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

Our available for sale portfolio is carried at estimated fair value, with any unrealized gains and losses, net of taxes, reported as accumulated other comprehensive income in shareholders' equity. We conduct a periodic review and evaluation of the securities portfolio to determine if the value of any security has declined below its carrying value and whether such decline is other than temporary. If such decline is deemed other than temporary, we would adjust the carrying amount of the security by writing down the

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security to fair value through a charge to current period income. The fair values of our securities are significantly affected by changes in interest rates.

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

*Allowance for Loan Losses*

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

The allowance for loan losses is an estimate of probable incurred losses with regard to our loans. Our loan loss provision for each period is dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loans, delinquencies, management's assessment of the quality of the loans, the valuation of problem loans and the general economic conditions in our market area. We base our allowance for loan losses on an estimation of probable losses inherent in our loan portfolio.

Our methodology for assessing loan loss allowances are intended to reduce the differences between estimated and actual losses and involves a detailed analysis of our loan portfolio, in three phases:

- the specific review of individual loans,
  
- the segmenting and review of loan pools with similar characteristics, and
  
- our judgmental estimate based on various subjective factors:

The first phase of our methodology involves the specific review of individual loans to identify and measure impairment. We evaluate each loan by use of a risk rating system, except for homogeneous loans, such as automobile loans and home mortgages. Specific risk rated loans are deemed impaired if all amounts, including principal and interest, will likely not be collected in accordance with the contractual terms of the related loan agreement. Impairment for commercial and real estate loans is measured either based on the present value of the loan's expected future cash flows or, if collection on the loan is collateral dependent, the estimated fair value of the collateral, less selling and holding costs.

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

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

- concentration of credits,
  
- nature and volume of the loan portfolio,
  
- delinquency trends,
  
- non-accrual loan trend,
  
- problem loan trend,
  
- loss and recovery trend,
  
- quality of loan review,
  
- lending and management staff,

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- lending policies and procedures,
  
- economic and business conditions, and
  
- other external factors.

Our management estimates the probable effect of such conditions based on our judgment, experience and known or anticipated trends. Such estimation may be reflected as an additional allowance to each group of loans, if necessary. Management reviews these conditions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specific, identifiable problem credit or portfolio segment as of the evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the unallocated allowance.

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

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the overall loan portfolio, however, the loan portfolio can be adversely affected if the State of California's economic conditions and its real estate market in our general market area were to further deteriorate or weaken. Additionally, further weakness of a prolonged nature in the agricultural and general economy would have a negative impact on the local market. The effect of such economic events, although uncertain and unpredictable at this time, could result in an increase in the levels of nonperforming loans and additional loan losses, which could adversely affect our future growth and profitability. No assurance of the level of predicted credit losses can be given with any certainty.

***Non-Accrual Loan Policy***

Interest on loans is credited to income as earned and is accrued only if deemed collectible. Accrual of interest is discontinued when a loan is over 90 days delinquent or if management believes that collection is highly uncertain. Generally, payments received on nonaccrual loans are recorded as principal reductions. Interest income is recognized after all principal has been repaid or an improvement in the condition of the loan has occurred that would warrant resumption of interest accruals.

***Stock-Based Compensation***

The Company recognizes in the consolidated statements of income the grant-date fair value of stock options and other equity-based forms of compensation issued to employees over the employees' requisite service period (generally the vesting period). The Company uses straight-line recognition of expenses for awards with graded vesting. The Company utilizes a binomial pricing model for all stock option grants. Expected volatility is based on the historical volatility of the price of the Company's stock. The Company uses historical data to estimate option exercise and stock option forfeiture rates within the valuation model. The expected term of options granted for the binomial model is derived from applying a historical suboptimal exercise factor to the contractual term of the grant. For binomial pricing, the risk-free rate for periods is equal to the U.S. Treasury yield at the time of grant and commensurate with the contractual term of the grant. For restricted stock grants, the Company uses the market price of the stock on the grant date and expenses the market value over the vesting period.

### ***Income Taxes***

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to

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the period in which the deferred tax assets or liabilities are expected to be realized or settled using the liability method. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company files income tax returns in the U.S. federal jurisdiction, and the state of California. With few exceptions, the Company is no longer subject to U.S. federal or state/local income tax examinations by tax authorities for years before 2008.

***Deferred Compensations Plans***

Future compensation under the Company's executive salary continuation plan and director retirement plan is earned for services rendered through retirement. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Company's current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 20 years.

***Fair Value Measurements***

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

We have established and documented a process for determining fair value. We maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. Whenever there is no readily available market data, management uses its best estimate and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial statements. For detailed information on our use of fair value measurements and our related valuation methodologies, see Note 17 to the Consolidated Financial Statements in Item 8 of this Form 10-K.

**Recently Issued Accounting Standards**

In May 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-04 Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The ASU improves the comparability of fair value measurements presented and disclosed in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs) by changing the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and disclosure of information. The amendments to this ASU provide explanation on how to measure fair value but do not require any

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additional fair value measurements and does not establish valuation standards or affect valuation practices outside of financial reporting. The amendments clarify existing fair value measurements and disclosure requirements to include application of the highest and best use and valuation premises concepts; measuring fair value of an instrument classified in a reporting entity's shareholders' equity; and disclosures requirements regarding quantitative information about unobservable inputs categorized within Level 3 of the fair value hierarchy. In addition, clarification is provided for measuring the fair value of financial instruments that are managed in a portfolio and the application of premiums and discounts in a fair value measurement. For public entities, ASU 2011-04 is effective during interim and annual periods beginning after December 15, 2011. There was no significant impact on the Company's financial position or results of operations as a result of adopting this ASU.

In June 2011, the FASB issued ASU No. 2011-05 Comprehensive Income (Topic 220) Presentation of Comprehensive Income. The ASU improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. The amendments to Topic 220, Comprehensive Income, require entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Entities are no longer permitted to present components of other comprehensive income as part of the statement of changes in stockholders' equity. Any adjustments for items that are reclassified from other comprehensive income to net income are to be presented on the face of the entities financial statement regardless the method of presentation for comprehensive income. The amendments do not change items to be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do the amendments



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change the option to present the components of other comprehensive income either net of related tax effects or before related tax effects. ASU 2011-05 is effective for fiscal years, and interim periods beginning on or after December 15, 2011. The Company adopted this ASU in the first quarter of 2012.

In December 2011, the FASB issued ASU No. 2011-11, Disclosures about Offsetting Assets and Liabilities. The update requires an entity to offset, and present as a single net amount, a recognized eligible asset and a recognized eligible liability when it has an unconditional and legally enforceable right of setoff and intends either to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously. The ASU requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued ASU No. 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The Update clarifies that ASU 2011-11 applies only to derivatives, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset or subject to an enforceable master netting arrangement or similar agreement. Entities with other types of financial assets and financial liabilities subject to a master netting arrangement or similar agreement are no longer subject to the disclosure requirements in ASU 2011-11. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The Update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

**Results of Operations**

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 interest-bearing liabilities. The second is noninterest income, which primarily consists of deposit service charges and fees, the increase in cash surrender value of life insurance and mortgage commissions. The majority of the Company's noninterest expenses are operating costs that relate to providing a full range of banking services to our customers.

**Overview**

We recorded net income available to common shareholders for the year ended December 31, 2012 of \$5,329,000 or \$0.69 per diluted common share compared to \$4,700,000 or \$0.61 per diluted common share for the year ended December 31, 2011. The increase in net income available to

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common shareholders for the year ended December 31, 2012 was primarily due to a decrease of \$350,000 in provision for loan losses, an increase in non-interest income of \$398,000 and a decrease in income tax provision of \$362,000. Partially offsetting these factors was a decrease in net interest income of \$335,000 and an increase of \$855,000 in non-interest expense associated with two new branch openings in 2011.

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Highlights of the financial results are presented in the following table:

| (Dollars in thousands, except per share data) | As of and for the years ended December 31, |            |            |
|---|--|------------|------------|
|   | 2012                                       | 2011       | 2010       |
| For the period:                               |  |            |            |
| Net income available to common shareholders   | \$ 5,329                                   | \$ 4,700   | \$ 3,786   |
| Net income per common share:                  |  |            |            |
| Basic   | \$ 0.69                                    | \$ 0.61    | \$ 0.49    |
| Diluted                                       | \$ 0.69                                    | \$ 0.61    | \$ 0.49    |
| Return on average common equity               | 8.80%                                      | 8.67%      | 7.65%      |
| Return on average assets                      | 0.95%                                      | 1.02%      | 0.88%      |
| Common stock dividend payout ratio            | 0.00%                                      | 0.00%      | 0.00%      |
| Efficiency ratio                              | 63.83%                                     | 61.28%     | 59.62%     |
| At period end:                                |  |            |            |
| Book value per common share                   | \$ 7.99                                    | \$ 7.37    | \$ 6.64    |
| Total assets                                  | \$ 660,581                                 | \$ 612,172 | \$ 552,396 |
| Total gross loans                             | \$ 390,986                                 | \$ 396,202 | \$ 404,194 |
| Total deposits                                | \$ 586,993                                 | \$ 536,204 | \$ 476,739 |
| Net loan-to-deposit ratio                     | 65.15%                                     | 72.17%     | 82.90%     |

***Net Interest Income and Net Interest Margin***

Our primary source of revenue is net interest income, which is the difference between interest and fees derived from earning assets and interest paid on liabilities obtained to fund those assets. Our net interest income is affected by changes in the level and mix of interest-earning assets and interest-bearing liabilities, referred to as volume changes. Our net interest income is also affected by changes in the yields earned on assets and rates paid on liabilities, referred to as rate changes. Interest rates charged on our loans are affected principally by the demand for such loans, the supply of money available for lending purposes and competitive factors. Those factors are, in turn, affected by general economic conditions and other factors beyond our control, such as federal economic policies, the general supply of money in the economy, legislative tax policies, the governmental budgetary matters, and the actions of the Federal Reserve Board.

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For a detailed analysis of interest income and interest expense, see the Average Balance Sheets and the Rate/Volume Analysis below.

**Distribution, Yield and Rate Analysis of Net Income  
For the Years Ended December 31,**

|   | Average<br>Balance | 2012<br>Interest<br>Income/<br>Expense | Avg<br>Rate/<br>Yield | Average<br>Balance | 2011<br>Interest<br>Income/<br>Expense | Avg<br>Rate/<br>Yield |
|---|--------------------|--|-----------------------|--------------------|--|-----------------------|
| <b>Assets:</b>                              |                    |  |                       |                    |  |                       |
| Earning assets:                             |                    |  |                       |                    |  |                       |
| Gross loans (1) (2)                         | \$ 390,856         | \$ 22,459                              | 5.75%                 | \$ 394,130         | \$ 23,619                              | 5.99%                 |
| Securities of U.S. government agencies      | 3,749              | 46                                     | 1.23%                 | 4,775              | 90                                     | 1.88%                 |
| Other investment securities (2)             | 95,405             | 3,720                                  | 3.90%                 | 69,518             | 3,274                                  | 4.71%                 |
| Federal funds sold                          | 12,339             | 29                                     | 0.24%                 | 17,804             | 42                                     | 0.24%                 |
| Interest-earning deposits                   | 54,676             | 135                                    | 0.25%                 | 40,902             | 100                                    | 0.24%                 |
| Total interest-earning assets               | 557,025            | 26,389                                 | 4.74%                 | 527,129            | 27,125                                 | 5.15%                 |
| Total noninterest earning assets            | 52,996             |  |                       | 45,774             |  |                       |
| Total Assets                                | \$ 610,021         |  |                       | \$ 572,903         |  |                       |
| <b>Liabilities and Shareholders Equity:</b> |                    |  |                       |                    |  |                       |
| Interest-bearing liabilities:               |                    |  |                       |                    |  |                       |
| Business interest DDA                       | 3,010              | 5                                      | 0.17%                 | 0                  | 0                                      | 0.00                  |
| MONEY market deposits                       | 249,652            | 513                                    | 0.21%                 | 245,815            | 767                                    | 0.31%                 |
| NOW deposits                                | 68,454             | 103                                    | 0.15%                 | 66,157             | 133                                    | 0.20%                 |
| Savings deposits                            | 26,238             | 57                                     | 0.22%                 | 18,389             | 64                                     | 0.35%                 |
| Time certificates of \$100,000 or more      | 37,150             | 322                                    | 0.87%                 | 35,172             | 356                                    | 1.01%                 |
| Other time deposits                         | 21,822             | 132                                    | 0.60%                 | 28,755             | 260                                    | 0.90%                 |
| Other borrowings                            | 467                | 4                                      | 0.86%                 | 6,484              | 68                                     | 1.05%                 |
| Total interest-bearing liabilities          | 406,793            | 1,136                                  | 0.28%                 | 400,772            | 1,648                                  | 0.41%                 |
| Noninterest-bearing liabilities:            |                    |  |                       |                    |  |                       |
| Noninterest-bearing deposits                | 130,664            |  |                       | 101,599            |  |                       |
| Other liabilities                           | 3,154              |  |                       | 2,820              |  |                       |
| Total noninterest-bearing liabilities       | 133,818            |  |                       | 104,419            |  |                       |
| Shareholders equity                         | 69,410             |  |                       | 67,712             |  |                       |
| Total liabilities and shareholders equity   | \$ 610,021         |  |                       | \$ 572,903         |  |                       |
| Net interest income                         |                    | \$ 25,253                              |                       |                    | \$ 25,477                              |                       |
| Net interest spread (3)                     |                    |  | 4.46%                 |                    |  | 4.73%                 |
| Net interest margin (4)                     |                    |  | 4.53%                 |                    |  | 4.83%                 |

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

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

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

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

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Net interest income, on a fully tax equivalent basis (FTE), decreased \$0.2 million or 0.9% to \$25.3 million for the year ended December 31, 2012, compared to \$25.5 million in 2011. Net interest spread and net interest margin were 4.46% and 4.53%, respectively, for the year ended December 31, 2012, compared to 4.73% and 4.83%, respectively, for the year ended December 31, 2011. The decrease in the net interest margin in 2012 was primarily attributable to the increased average federal funds sold and interest earning deposits in bank balances of \$8.3 million which are earning 0.24% and thus driving down the overall yield on earning assets. Additionally, the average balance of our investment portfolio increased by \$24.9 million and the yield decreased by 73 basis points in 2012 compared to 2011.

The current low market interest rate environment has had a positive impact on net interest income in previous years because the Company's consolidated balance sheet is liability sensitive which typically results in our average cost of funds decreasing faster than the average yield on interest earning assets in a declining rate environment. In 2012, we have not recognized this benefit to the same degree, as deposit interest rates are at historic lows and have essentially reached a threshold in which they cannot reasonably be further reduced to keep pace with the reduction of our asset yield. However, the total cost of funds did decrease 13 basis points in 2012 compared to 2011, due to moderate rate reductions across all deposit products. In addition, average non-interest-bearing demand deposit balances increased by \$29.1 million in 2012 compared to 2011, further reducing our cost of funds.

Compared to cost of funds, the decrease in earning asset yield was more significant at 41 basis points in 2012 compared to 2011. The investment securities portfolio recognized the most significant decrease of 73 basis points in 2012, mainly because of the Company deploying cash into investment security purchases, which have historically low yields. The yield on loans has remained more stable, with a reduction of 24 basis points for 2012 compared to 2011, partly as a result of the significant portion of our loans that are at their contractual rate floors. In addition, the large majority of our variable loans are tied to the U.S. Treasury Constant Maturity Indices with repricing intervals between one and five years.

Changes in volume resulted in an increase in net interest income (FTE) of \$1,087,000 for the year of 2012 compared to the year 2011, and changes in interest rates and the mix resulted in a decrease in net interest income (FTE) of \$1,311,000 for the year 2012 versus the year 2011. Management closely monitors both total net interest income and the net interest margin.

Market rates are in part based on the Federal Reserve Open Market Committee ( FOMC ) target Federal funds interest rate (the interest rate banks charge each other for short-term borrowings). The change in the Federal funds sold and purchased rates is the result of target rate changes implemented by the FOMC. In 2008, there were seven downward adjustments to the target rate totaling 325 basis points, bringing the target interest rate to a historic low with a range of 0% to 0.25% where it remained as of December 2012.

Table of Contents**Rate/Volume Analysis**

The following table below sets forth certain information regarding changes in interest income and interest expense of the Company for the periods indicated. For each category of earning assets and interest bearing liabilities, information is provided on changes attributable to (i) changes in volume (change in average volume multiplied by old rate); and (ii) changes in rates (change in rate multiplied by old average volume). Changes in rate/volume (change in rate multiplied by the change in volume) have been allocated to the changes due to volume and rate in proportion to the absolute value of the changes due to volume and rate prior to the allocation.

|  | <b>Rate/Volume Analysis of Net Interest Income</b>       |             |              |  |             |              |
|--|--|-------------|--------------|--|-------------|--------------|
|  | <b>For the Year Ended December 31,<br/>2012 vs. 2011</b> |             |              | <b>For the Year Ended December 31,<br/>2011 vs. 2010</b> |             |              |
|  | <b>Increases (Decreases)<br/>Due to Change In</b>        |             |              | <b>Increases (Decreases)<br/>Due to Change In</b>        |             |              |
|  | <b>Volume</b>  | <b>Rate</b> | <b>Total</b> | <b>Volume</b>  | <b>Rate</b> | <b>Total</b> |
| <b>Interest income:</b>                |  |             |              |  |             |              |
| Net loans (1)                          | \$ (196)   | \$ (964)    | \$ (1,160)   | \$ (1,083)   | \$ (834)    | \$ (1,917)   |
| Securities of U.S. government agencies | (19)   | (25)        | (44)         | 19   | 62          | 81           |
| Other Investment securities            | 1,219  | (773)       | 446          | 1,190  | (513)       | 677          |
| Federal funds sold                     | (13)   | 0           | (13)         | 22   | 1           | 23           |
| Interest-earning deposits              | 34   | 1           | 35           | 58   | 0           | 58           |
| Total interest income                  | 1,025  | (1,761)     | (736)        | 206  | (1,284)     | (1,078)      |
| <b>Interest expense:</b>               |  |             |              |  |             |              |
| Business interest DDA                  | \$ 0   | \$ 5        | \$ 5         | \$ 0   | \$ 0        | \$ 0         |
| Money market deposits                  | 12   | (266)       | (254)        | 214  | (821)       | (607)        |
| NOW deposits                           | 5  | (35)        | (30)         | 20   | (73)        | (53)         |
| Savings deposits                       | 27   | (34)        | (7)          | 15   | (13)        | 2            |
| Time certificates of \$100,000 or more | 20   | (54)        | (34)         | (87)   | (67)        | (154)        |
| Other time deposits                    | (63)   | (65)        | (128)        | (63)   | (136)       | (199)        |
| Other borrowings                       | (63)   | (1)         | (64)         | (217)  | (43)        | (260)        |
| Total interest expense                 | (62)   | (450)       | (512)        | (118)  | (1,153)     | (1,271)      |
| Change in net interest income          | \$ 1,087   | \$ (1,311)  | \$ (224)     | \$ 324   | \$ (131)    | \$ 193       |

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

**Provision for Loan Losses**

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are shown in the consolidated statements of income as the provision for loan losses. Specifically identifiable and quantifiable losses are promptly charged off against the allowance. The Company maintains the allowance for loan losses at a level that it considers to be adequate to provide for credit losses inherent in its loan portfolio. Management determines the level of the allowance by performing a quarterly analysis that considers concentrations of credit, past loss experience, current economic conditions, the amount and composition of the loan portfolio (including nonperforming and potential problem loans), estimated fair value of underlying collateral, and other information relevant to assessing the risk of loss inherent in the loan portfolio such as for example loan growth, net charge-offs, changes in the composition of the loan portfolio, and delinquencies. As a result of management's analysis, a range of the potential amount of the allowance for loan losses is determined.

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The provision for loan losses was \$1,150,000 for the year ended December 31, 2012, compared to \$1,500,000 for the year end December 31, 2011. Nonperforming loans were \$6.92 million at December 31, 2012 and \$7.23 million at December 31, 2011, or 1.77% and 1.83%, respectively, of total loans. Nonperforming loans are primarily in nonperforming real estate construction and development loans. The allowance for loan losses was \$7.97 million and \$8.61 million at December 31, 2012 and 2011, or 2.04% and 2.17%, respectively, of total loans. Net charge-offs were \$1,784,000 in 2012 compared to \$1,146,000 in 2011. The relatively high

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level of net charge-offs for 2012 and 2011 as compared to all prior years was primarily due to prolonged effect of the stagnant economic period.

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

***Noninterest Income***

Noninterest income was \$3.15 million for the year ended December 31, 2012, compared to \$2.75 million for the year 2011. In 2012, other income increased by \$217,000, which was partially attributable to a \$120,000 operating recovery from a prior year items processing loss. Mortgage commissions have increased by \$136,000 or 131% for the year 2012, as compared to 2011 as a result of the escalated demand for home purchases and refinancing due in part to the current low interest rate environment. Service charge income increased to \$1.17 million for the year 2012 compared to \$1.12 million for the year 2011, as a result of the increase in the aggregate number of deposit accounts of 2.9% to 23,009 at December 31, 2012, as compared to 22,371 accounts as of December 31, 2011. The Company continues to evaluate its deposit product offerings with the intention of continuing to expand its offerings to the consumer and business depositors.

**Noninterest Income****(Dollars in thousands)**

|  | For the Years Ended December 31, |               |                 |               |
|--|----------------------------------|---------------|-----------------|---------------|
|  | 2012                             |               | 2011            |               |
|  | (Amount)                         | (%)           | (Amount)        | (%)           |
| Service charges on deposit accounts                | \$ 1,173                         | 37.3%         | \$ 1,120        | 40.7%         |
| Earnings on cash surrender value of life insurance | 424                              | 13.5%         | 432             | 15.7%         |
| Mortgaged commissions                              | 240                              | 7.6%          | 104             | 3.8%          |
| Other income                                       | 1,312                            | 41.6%         | 1,095           | 39.8%         |
| <b>Total</b>                                       | <b>\$ 3,149</b>                  | <b>100.0%</b> | <b>\$ 2,751</b> | <b>100.0%</b> |
| Average assets                                     | \$ 610,021                       |               | \$ 572,903      |               |
| Noninterest income as a % of average assets        |                                  | 0.5%          |                 | 0.5%          |

***Noninterest Expense***

The following table sets forth a summary of noninterest expenses for the periods indicated:

**Noninterest Expense**



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(Dollars in thousands)

|   | For the Years Ended December 31, |        |            |        |
|---|----------------------------------|--------|------------|--------|
|   | 2012                             |        | 2011       |        |
|   | (Amount)                         | (%)    | (Amount)   | (%)    |
| Salaries and employee benefits                | \$ 10,009                        | 54.8%  | \$ 9,326   | 53.6%  |
| Occupancy expenses                            | 2,948                            | 16.2%  | 2,829      | 16.3%  |
| Data processing fees                          | 1,128                            | 6.2%   | 1,016      | 5.8%   |
| OREO expenses                                 | 27                               | 0.1%   | 389        | 2.2%   |
| Regulatory assessments (FDIC & DFI)           | 461                              | 2.5%   | 642        | 3.7%   |
| Other operating expenses                      | 3,675                            | 20.2%  | 3,192      | 18.4%  |
| Total   | \$ 18,248                        | 100.0% | \$ 17,394  | 100.0% |
| Average assets                                | \$ 610,021                       |        | \$ 572,903 |        |
| Noninterest expenses as a % of average assets |                                  | 3.0%   |            | 3.0%   |

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Noninterest expense was \$18,248,000 for the year ended December 31, 2012, an increase of \$854,000 or 4.9% compared to \$17,394,000 for the year ended 2011.

Salaries and employee benefits increased by \$683,000 in 2012 to \$10,009,000 as a result of hiring staff for two new branches opened in 2011 and additional stock based compensation expense corresponding to restricted stock awards issued to employees. The two new branches also resulted in an increase of \$119,000 in occupancy expenses in 2012 compared to 2011, primarily from building lease expense and building depreciation, as one of the branches was leased and the other was purchased.

Data processing costs increased in 2012 over 2011 by \$112,000, reflecting the additional costs that related to the increased number of deposit accounts.

Other expenses recognized an increase in 2012 compared to 2011 of \$483,000 due in part to a \$75,000 insurance retention accrual recorded in 2012, overhead expenses from our new branches and various costs associated with the expansion of products and services.

OREO expenses decreased by \$362,000 to \$27,000 in 2012, compared to \$389,000 in 2011. Included within these totals is a gain on sale of an OREO property of \$4,000 in 2012. There were no OREO write downs in 2012 compared to write downs of \$291,000 in 2011. The remaining expense included in OREO expenses is attributed to general overhead such as property taxes and utilities associated with the properties classified as other real estate owned. There was one sale of an OREO property recorded in 2012 which reduced our OREO inventory from two properties as of December 31, 2011 to one property as of December 31, 2012. The Company did not acquire any additional OREO during 2011 or 2012.

FDIC and DFI (California Department of Financial Institutions) regulatory assessments decreased by \$181,000 to \$461,000 in 2012 compared to \$642,000 in 2011. The initial base assessment rate for financial institutions varies based on the overall risk profile of the institution as defined by the FDIC. The decrease in 2012 is due to a lower base assessment rate as the Company has improved its overall risk ratings. The decrease in expense was in spite of a higher deposit base in 2012 as compared to 2011, as the FDIC assessment rates are applied to average quarterly total liabilities as the primary basis.

Management anticipates that noninterest expense will continue to increase as we continue to grow, even though management also estimates that the Company's administration as currently set up may be scalable to handle a larger deposit base of up to around \$1B in deposits. However, management remains committed to cost-control and efficiency, and we expect to keep these increases to a minimum relative to growth.

***Provision for Income Taxes***

We reported a provision for income taxes of \$2,814,000 and \$3,176,000 for the years 2012 and 2011 respectively. The effective income tax rate on income from continuing operations was 32.7% for the year ended December 31, 2012 compared to 35.1% for the year 2011. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, BOLI and certain tax-exempt loans). The disparity between the effective tax rates in 2012 as compared to 2011 is

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primarily due to tax credits from California Enterprise Zones and low income housing projects as well as tax free-income on loans within these enterprise zones and municipal securities and loans that comprise a larger proportion of pre-tax income in 2012 as compared to 2011. We have not been subject to an alternative minimum tax ( AMT ) during these periods.

### **Financial Condition**

The Company's total assets were \$660.6 million at December 31, 2012 compared to \$612.2 million at December 31, 2011, an increase of \$48.4 million or 7.9%. Net loans decreased \$4.5 million, investments increased \$14.2 million, bank premises and equipment decreased \$317,000 and interest receivable and other assets decreased \$904,000, while cash and cash equivalents increased \$40.3 million for the year ended December 31, 2012 as compared to December 31, 2011.

Loans gross of the allowance for loan losses and deferred fees were \$391.0 million at December 31, 2012, compared to \$396.2 million at December 31, 2011, a decrease of \$5.2 million or 1.3%. The decrease was primarily due to a decrease of \$13.7 million or 4.2% in commercial real estate loans. This was offset by increases of \$4.5 million in commercial and industrial loans, \$2.6 million in agriculture loans, and an increase of \$1.3 million in consumer loans and consumer residential loans. The composition of the loan

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portfolio categories remained relatively unchanged as a percentage of total loans, except for commercial real estate loans which recognized the highest change from 83.3% at December 31, 2011 to 80.8% at December 31, 2012. This increase was offset by moderate increases in all other loan categories.

Deposits increased \$50.8 million or 9.5% to \$587.0 million at December 31, 2012 compared to \$536.2 million at December 31, 2011. Time deposits and Money Market deposits decreased by \$1.9 million and \$15.0 million, respectively, while Demand, NOW and Savings each increased by \$45.4 million, \$11.0 million and \$11.3 million, respectively, as of December 31, 2012 as compared to December 31, 2011.

Short-term borrowings were fully paid off during 2012 to leave no outstanding balances at December 31, 2012, compared to \$3.0 million at December 31, 2011. There was no long-term debt outstanding at December 31, 2012 and December 31, 2011. The decrease in short-term borrowings was due to the deposit growth of \$50.8 million. This allowed us to pay off matured FHLB advances thus reducing our cost of funds and lowering our liquidity ratio, which has been running at a surplus in recent years. The Company uses short-term borrowings, primarily short-term FHLB advances, to fund short-term liquidity needs and manage net interest margin.

Equity decreased \$433,000 or 0.6% to \$70.0 million at December 31, 2012, compared to \$70.4 million at December 31, 2011. The Company was selected to participate in the U.S. Treasury Capital Purchase Program ( TCPP ) which resulted in the issuance of \$13.5 million in preferred stock in December 2008. In August 2011, the Company repurchased these Series A preferred stock shares and simultaneously issued \$13,500,000 in Series B Preferred Stock to the U.S. Treasury under the Small Business Lending Funding ( SBLF ) program. Subsequently, the Company fully redeemed a warrant to purchase 350,346 shares of its Common Stock, at the exercise price of \$5.78 per share that the Company had granted to the U.S. Treasury pursuant to the TCPP, for a purchase price of \$560,000, which settled in September 2011. In May 2012, the Company repurchased from the U.S. Treasury 6,750 shares of Series B Preferred Stock for aggregate consideration of \$6.75 million. Thereafter, in March 2013, the Company repurchased from the U.S. Treasury the remaining 6,750 shares of Series B Preferred Stock for aggregate consideration of \$6,817,500, reflecting \$6,750,000 paid for the repurchase, and \$67,500 paid for accrued dividends. The securities issued to the Treasury were accounted for as components of regulatory Tier 1 capital. See Notes 3 and 24 to the Consolidated Financial Statements in Item 8 of this report for further discussion regarding our participation in the TCPP and SBLF.

*Investment Activities*

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

*Cash Equivalents and Interest-bearing Deposits in other Financial Institutions*

The Company holds federal funds sold, unpledged available-for-sale securities and salable government guaranteed loans to help meet liquidity requirements and provide temporary holdings until the funds can be otherwise deployed or invested. As of December 31, 2012, and 2011, we had \$10.5 million and \$27.9 million, respectively, in federal funds sold.

*Investment Securities*

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

Our investment securities holdings increased by \$14.2 million, or 15.8%, to \$103.9 million at December 31, 2012, compared to holdings of \$89.7 million at December 31, 2011. Total investment securities as a percentage of total assets increased to 15.7% as of December 31, 2012 compared to 14.7% at December 31, 2011. As of December 31, 2012, \$56.5 million of the investment securities were pledged to secure public deposits.

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As of December 31, 2012, the total unrealized loss on securities that were in a loss position for less than 12 continuous months was \$99,000 with an aggregate fair value of \$5,792,000. The total unrealized loss on securities that were in a loss position for greater than 12 continuous months was \$14,000 with an aggregate fair value of \$1,281,000.

The following table summarizes the book value and market value and distribution of our investment securities as of the dates indicated:

**Investment Securities Portfolio**

| Dollars in Thousands                | As of December 31, 2012 |              | As of December 31, 2011 |              | As of December 31, 2010 |              |
|-------------------------------------|-------------------------|--------------|-------------------------|--------------|-------------------------|--------------|
|                                     | Amortized Cost          | Market Value | Amortized Cost          | Market Value | Amortized Cost          | Market Value |
| <b>Available-for-Sale:</b>          |                         |              |                         |              |                         |              |
| U.S. agencies                       | \$ 52,608               | \$ 55,518    | \$ 52,102               | \$ 54,809    | \$ 28,679               | \$ 30,190    |
| Collateralized mortgage obligations | 11,698                  | 12,604       | 11,366                  | 12,095       | 7,947                   | 8,137        |
| Municipalities                      | 25,323                  | 26,992       | 15,660                  | 16,972       | 9,871                   | 10,800       |
| SBA Pools                           | 1,178                   | 1,178        | 1,236                   | 1,237        | 1,517                   | 1,506        |
| Corporate debt                      | 4,669                   | 4,706        | 2,000                   | 1,814        | 0                       | 0            |
| Mutual Fund                         | 2,875                   | 2,868        | 2,759                   | 2,768        | 2,631                   | 2,635        |
| Total investment securities         | \$ 98,351               | \$ 103,866   | \$ 85,123               | \$ 89,695    | \$ 50,645               | \$ 53,268    |

At December 31, 2012, one SBA pool and one mutual fund make up the total amount of securities in an unrealized loss position for greater than 12 months, and one U.S. agency, five municipalities and one corporate debt security make up the total amount of securities in an unrealized loss position for less than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security's fair value. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Bank does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security. As of December 31, 2012, we did not have any investment securities that constituted 10% or more of the stockholders' equity of any third party issuer.

The following table summarizes the maturity and repricing schedule of our investment securities at their amortized cost and their weighted average yields at December 31, 2012:

**Investment Maturities and Repricing Schedule**

(Dollars in Thousands)

| Within One Year | After One But Within Five Years | After Five But Within Ten Years | After Ten Years | Total |
|-----------------|---------------------------------|---------------------------------|-----------------|-------|
|-----------------|---------------------------------|---------------------------------|-----------------|-------|

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|  | Amount    | Yield | Amount    | Yield | Amount    | Yield | Amount    | Yield | Amount    | Yield |
|--|-----------|-------|-----------|-------|-----------|-------|-----------|-------|-----------|-------|
| <b>Available-for-sale:</b>             |           |       |           |       |           |       |           |       |           |       |
| Securities of U.S. government agencies | \$ 9,668  | 1.02% | \$ 6,428  | 4.09% | \$ 9,432  | 4.24% | \$ 27,080 | 3.17% | \$ 52,608 | 3.08% |
| Collateralized mortgage obligations    | 0         | 0.00% | 0         | 0.00% | 0         | 0.00% | 11,698    | 3.32% | 11,698    | 3.32% |
| Municipal securities                   | 1,400     | 4.52% | 6,001     | 5.43% | 17,056    | 2.71% | 866       | 3.21% | 25,323    | 3.47% |
| SBA Pools                              | 0         | 0.00% | 0         | 0.00% | 0         | 0.00% | 1,178     | 1.00% | 1,178     | 1.00% |
| Corporate debt                         | 0         | 0.00% | 4,669     | 2.35% | 0         | 0.00% | 0         | 0.00% | 4,669     | 2.35% |
| Mutual Fund                            | 0         | 0.00% | 0         | 0.00% | 0         | 0.00% | 2,875     | 0.00% | 2,875     | 0.00% |
| Total Investment Securities            | \$ 11,068 | 1.46% | \$ 17,098 | 3.45% | \$ 26,488 | 3.67% | \$ 43,697 | 2.88% | \$ 98,351 | 3.03% |

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Yields in the above table have not been adjusted to a fully tax equivalent basis.

### Loans

The following table sets forth the amount of total loans outstanding (excluding unearned income) and the percentage distributions in each category, as of the dates indicated.

|   | YEARS ENDED DECEMBER 31, |            |            |            |            |  |
|---|--------------------------|------------|------------|------------|------------|--|
|   | 2012                     | 2011       | 2010       | 2009       | 2008       |  |
| Commercial real estate                            | \$ 316,075               | \$ 330,045 | \$ 336,730 | \$ 353,171 | \$ 354,401 |  |
| Commercial and industrial                         | 36,529                   | 32,018     | 30,756     | 38,160     | 37,302     |  |
| Consumer  | 1,096                    | 1,213      | 1,242      | 1,351      | 1,281      |  |
| Consumer residential                              | 25,659                   | 23,871     | 21,844     | 20,117     | 21,613     |  |
| Agriculture                                       | 11,628                   | 9,056      | 13,622     | 12,828     | 13,580     |  |
| Unearned income                                   | (600)                    | (634)      | (733)      | (811)      | (1,035)    |  |
| Total Loans, net of unearned income               | \$ 390,387               | \$ 395,569 | \$ 403,461 | \$ 424,816 | \$ 427,142 |  |
| Participation loans sold and serviced by the Bank | 8,045                    | 7,929      | 9,283      | 14,907     | 9,759      |  |
| Commercial real estate:                           | 80.9%                    | 83.5%      | 83.5%      | 83.1%      | 83.0%      |  |
| Commercial and Industrial                         | 9.4%                     | 8.1%       | 7.6%       | 9.0%       | 8.7%       |  |
| Consumer  | 0.3%                     | 0.3%       | 0.3%       | 0.3%       | 0.3%       |  |
| Consumer residential                              | 6.6%                     | 6.0%       | 5.4%       | 4.7%       | 5.1%       |  |
| Agriculture                                       | 3.0%                     | 2.3%       | 3.4%       | 3.0%       | 3.2%       |  |
| Unearned income                                   | -0.2%                    | -0.2%      | -0.2%      | -0.2%      | -0.2%      |  |
| Total Loans, net of unearned income               | 100.0%                   | 100.0%     | 100.0%     | 100.0%     | 100.0%     |  |

Commercial real estate loans decreased \$14.0 million in 2012 as compared to 2011, as a result of the decline in demand by qualified borrowers in our serving area. Of the commercial real estate loans at December 31, 2012, 64.2% are non-owner occupied and 35.8% are owner occupied. Our commercial real estate loan portfolio is weighted towards term loans for which the primary source of repayment is cash flow from net operating income of the real estate property.

Commercial and industrial loans increased \$4.5 million in 2012 as compared to 2011, as a result of our reassessment of the commercial and industrial lending market, specifically asset-based lines of credit. We have historically targeted well-established local businesses with strong guarantors that have proven to be resilient in periods of economic stress.

Our residential loan portfolio includes no sub-prime loans, nor is it our normal practice to underwrite loans commonly referred to as Alt-A mortgages, the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or collateral compositions reflecting high loan-to-value ratios. Substantially all of our residential loans are indexed to Treasury Constant Maturity Rates and have provisions to reset five years after their origination dates.





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The following table summarizes our commercial real estate loan portfolio by the geographic location in which the property is located as of December 31, 2012 and 2011:

**Commercial Real Estate Loans Outstanding by Geographic Location**

| Commercial real estate loans by<br>geographic location (County) | December 31, 2012 |  | December 31, 2011 |  |
|---|-------------------|--|-------------------|--|
|   | Amount            | % of<br>Commercial<br>Real Estate<br>Loans | Amount            | % of<br>Commercial<br>Real Estate<br>Loans |
| Stanislaus  | \$ 127,310        | 40.4%                                      | \$ 140,679        | 42.6%                                      |
| San Joaquin   | 61,007            | 19.3%                                      | 60,607            | 18.4%                                      |
| Tuolumne  | 21,910            | 6.9%                                       | 23,763            | 7.2%                                       |
| Alameda   | 14,054            | 4.4%                                       | 14,346            | 4.3%                                       |
| Mono  | 13,333            | 4.2%                                       | 14,363            | 4.4%                                       |
| Sacramento  | 10,518            | 3.3%                                       | 11,055            | 3.3%                                       |
| Merced  | 9,246             | 2.9%                                       | 7,568             | 2.3%                                       |
| Fresno  | 7,894             | 2.5%                                       | 8,333             | 2.5%                                       |
| Madera  | 7,623             | 2.4%                                       | 7,235             | 2.2%                                       |
| Calaveras   | 5,923             | 1.9%                                       | 6,715             | 2.0%                                       |
| Contra Costa  | 5,031             | 1.6%                                       | 5,934             | 1.8%                                       |
| Marin   | 4,830             | 1.5%                                       | 3,890             | 1.2%                                       |
| Inyo  | 4,222             | 1.3%                                       | 9,234             | 2.8%                                       |
| Solano  | 3,500             | 1.1%                                       | 0                 | 0.0%                                       |
| Santa Clara   | 3,432             | 1.1%                                       | 3,674             | 1.1%                                       |
| Tulare  | 3,125             | 1.0%                                       | 3,503             | 1.1%                                       |
| Los Angeles   | 18                | 0.0%                                       | 23                | 0.0%                                       |
| Other   | 13,099            | 4.2%                                       | 9,123             | 2.8%                                       |
| <b>Total</b>  | <b>\$ 316,075</b> | <b>100.0%</b>                              | <b>\$ 330,045</b> | <b>100.0%</b>                              |

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Construction and land loans are classified as commercial real estate loans and decreased \$4.4 million in 2012 as compared to 2011, primarily due to the successful completion and sell-through of construction development projects booked in prior years, a slow down in construction activity (primarily residential development), as well as a conscious effort to reduce our concentration in construction loans. The table below shows an analysis of construction loans by type and location. Non-owner-occupied land loans of \$14.3 million at December 31, 2012 included loans for lands specified for commercial development of \$5.9 million and for residential development of \$8.4 million, the majority of which are located in Stanislaus County.

| (Dollars in Thousands)            | December 31, 2012 |                         | December 31, 2011 |                         |
|-----------------------------------|-------------------|-------------------------|-------------------|-------------------------|
|                                   | Amount            | % of Construction Loans | Amount            | % of Construction Loans |
| <b>Construction loans by type</b> |                   |                         |                   |                         |
| Single family non-owner-occupied  | \$ 738            | 3.5%                    | \$ 7,656          | 30.3%                   |
| Single family owner-occupied      | 263               | 1.3%                    | 1,354             | 5.4%                    |
| Commercial non-owner-occupied     | 2,114             | 10.1%                   | 5,373             | 21.3%                   |
| Commercial owner-occupied         | 3,467             | 16.6%                   | 212               | 0.8%                    |
| Land non-owner-occupied           | 14,269            | 68.5%                   | 10,636            | 42.2%                   |
| <b>Total</b>                      | <b>\$ 20,851</b>  | <b>100.0%</b>           | <b>\$ 25,231</b>  | <b>100.0%</b>           |

| Construction loans by geographic location (County) | December 31, 2012 |                         | December 31, 2011 |                         |
|--|-------------------|-------------------------|-------------------|-------------------------|
|  | Amount            | % of Construction Loans | Amount            | % of Construction Loans |
| Stanislaus   | \$ 9,526          | 45.7%                   | \$ 11,940         | 47.3%                   |
| San Joaquin  | 3,820             | 18.3%                   | 1,912             | 7.6%                    |
| Mono   | 3,141             | 15.1%                   | 3,227             | 12.8%                   |
| Merced   | 1,788             | 8.6%                    | 0                 | 0.0%                    |
| Inyo   | 1,076             | 5.2%                    | 965               | 3.8%                    |
| Contra Costa                                       | 663               | 3.2%                    | 1,479             | 5.9%                    |
| Madera   | 476               | 2.3%                    | 0                 | 0.0%                    |
| Calaveras  | 263               | 1.2%                    | 162               | 0.6%                    |
| Tuolumne   | 20                | 0.1%                    | 2,074             | 8.2%                    |
| Sutter   | 0                 | 0.0%                    | 3,050             | 12.1%                   |
| Tulare   | 0                 | 0.0%                    | 332               | 1.3%                    |
| Other  | 78                | 0.3%                    | 90                | 0.4%                    |
| <b>Total</b>                                       | <b>\$ 20,851</b>  | <b>100.0%</b>           | <b>\$ 25,231</b>  | <b>100.0%</b>           |

Table of Contents**Loan Maturities**

The following table shows the contractual maturity distribution and repricing intervals of the outstanding loans in our portfolio, as of December 31, 2012. In addition, the table shows the distribution of such loans between those with variable or floating interest rates and those with fixed or predetermined interest rates. The large majority of the variable rate loans are tied to independent indices (such as the Wall Street Journal prime rate or a Treasury Constant Maturity Rate). Substantially all loans with an original term of more than five years have provisions for the fixed rates to reset, or convert to a variable rate, after one, three or five years.

| (Dollars in thousands)                          | <b>Loan Maturities and Repricing Schedule</b> |  |                             |            | <b>Total</b> |
|---|---|--|-----------------------------|------------|--------------|
|   | <b>Within<br/>One Year</b>                    | <b>After One<br/>But Within<br/>Five Years</b> | <b>After<br/>Five Years</b> |            |              |
| Commercial real estate                          | \$ 69,491                                     | \$ 191,509                                     | \$ 55,075                   | \$ 316,075 |              |
| Commercial & Industrial                         | 24,449  | 9,231  | 2,849                       | 36,529     |              |
| Consumer  | 492   | 543  | 61                          | 1,096      |              |
| Consumer Residential                            | 5,488   | 8,353  | 11,818                      | 25,659     |              |
| Agriculture                                     | 9,374   | 1,294  | 960                         | 11,628     |              |
| Unearned income                                 | (168)   | (324)  | (108)                       | (600)      |              |
| Total loans, net of unearned income             | \$ 109,126                                    | \$ 210,606                                     | \$ 70,655                   | \$ 390,387 |              |
| Loans with variable (floating) interest rates   | \$ 95,090                                     | \$ 170,928                                     | \$ 35,079                   | \$ 301,097 |              |
| Loans with predetermined (fixed) interest rates | \$ 14,036                                     | \$ 39,678                                      | \$ 35,576                   | \$ 89,290  |              |

The majority of the properties taken as collateral are located in Northern California. We employ strict guidelines regarding the use of collateral located in less familiar market areas. The recent decline in Northern California real estate value is offset by the low loan-to-value ratios in our commercial real estate portfolio and high percentage of owner-occupied properties.

**Nonperforming Assets**

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies which have brought about declines in overall property values. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

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

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

The Company had nonperforming loans of \$6.92 million at December 31, 2012, as compared to \$7.23 million at December 31, 2011, \$11.48 million at December 31, 2010, \$14.42 million at December 31, 2009, and \$4.08 million at December 31,

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2008. The ratio of nonperforming loans over total loans was 1.77%, 1.83%, 2.84%, 3.39% and 1.10% at December 31, 2012, 2011, 2010, 2009 and 2008, respectively.

In addition, the Company held one OREO property as of December 31, 2012, which consisted of residential land acquired through foreclosure that was written down to a zero balance because the public utilities have not been obtainable rendering these land lots unmarketable at this time. The Company held two properties with a market value of \$0.2 million as of December 31, 2011 as compared to three OREO properties with a market value of \$0.8 million as of December 31, 2010, six properties with a market value of \$2.1 million as of December 31, 2009 and two properties with a market value of \$2.7 million at December 31, 2008.

Management believes that the reserve provided for nonperforming loans, together with the tangible collateral, were adequate as of December 31, 2012. See Allowance for Loan Losses below for further discussion. Except as disclosed above, as of December 31, 2012, management was not aware of any material credit problems of borrowers that would cause it to have serious doubts about the ability of a borrower to comply with the present loan payment terms. However, no assurance can be given that credit problems may exist that may not have been brought to the attention of management, or that credit problems may arise.

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The following table provides information with respect to the components of our nonperforming assets as of the dates indicated. (The figures in the table are net of the portion guaranteed by the U.S. Government):

**Nonperforming Assets**

| (Dollars in Thousands)  | 2012 |         | 2011 |         | At December 31,<br>2010 |        | 2009 | 2008   |    |         |
|---|------|---------|------|---------|-------------------------|--------|------|--------|----|---------|
| <b>Nonaccrual loans(1)</b>  |      |         |      |         |                         |        |      |        |    |         |
| Commercial real estate  | \$   | 5,891   | \$   | 7,129   | \$                      | 11,253 | \$   | 12,701 | \$ | 4,078   |
| Commercial and industrial   |      | 21      |      | 104     |                         | 222    |      | 488    |    | 0       |
| Consumer  |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Consumer residential  |      | 1,011   |      | 0       |                         | 0      |      | 0      |    | 0       |
| Agriculture   |      | 0       |      | 0       |                         | 0      |      | 1,229  |    | 0       |
| Total   | \$   | 6,923   | \$   | 7,233   | \$                      | 11,475 | \$   | 14,418 | \$ | 4,078   |
| <b>Loans 90 days or more past due and still accruing (as to principal or interest):</b> |      |         |      |         |                         |        |      |        |    |         |
| Commercial real estate  | \$   | 0       | \$   | 0       | \$                      | 0      | \$   | 0      | \$ | 643     |
| Commercial and industrial   |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Consumer  |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Consumer residential  |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Agriculture   |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Total   |      | 0       |      | 0       |                         | 0      |      | 0      |    | 643     |
| Total nonperforming loans   |      | 6,923   |      | 7,233   |                         | 11,475 |      | 14,418 |    | 4,721   |
| Other real estate owned   |      | 0       |      | 244     |                         | 778    |      | 2,150  |    | 2,746   |
| Total nonperforming assets  | \$   | 6,923   | \$   | 7,477   | \$                      | 12,253 | \$   | 16,568 | \$ | 7,467   |
| <b>Accruing restructured loans (2)</b>  |      |         |      |         |                         |        |      |        |    |         |
| Commercial real estate  | \$   | 0       | \$   | 0       | \$                      | 0      | \$   | 0      | \$ | 0       |
| Commercial and industrial   |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Consumer  |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Consumer residential  |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Agriculture   |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Total   |      | 0       |      | 0       |                         | 0      |      | 0      |    | 0       |
| Total impaired loans  | \$   | 6,923   | \$   | 7,233   | \$                      | 11,475 | \$   | 14,418 | \$ | 4,721   |
| Nonperforming loans as a percentage of total loans                                      |      | 1.77%   |      | 1.83%   |                         | 2.84%  |      | 3.39%  |    | 1.10%   |
| Nonperforming assets as a percentage of total loans and other real estate owned         |      | 1.77%   |      | 1.89%   |                         | 3.03%  |      | 3.88%  |    | 1.74%   |
| Allowance for loan losses as a percentage of nonperforming loans                        |      | 115.19% |      | 119.03% |                         | 71.94% |      | 48.69% |    | 117.97% |

(1) During the fiscal year ended December 31, 2012 and 2011, no interest income related to these loans was included in net income while on nonaccrual status. Additional interest income of approximately \$696,000 and \$692,000 would have been recorded during the year ended December 31, 2012 and 2011, respectively, if these loans had been paid in accordance with their original terms.

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(2) A restructured loan is one the terms of which were renegotiated to provide a concession because of deterioration in the financial position of the borrower.



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*Allowance for Loan Losses*

In anticipation of credit risk inherent in our lending business, we set aside allowances through charges to earnings. Such charges are not only made for the outstanding loan portfolio, but also for off-balance sheet items, such as commitments to extend credits or letters of credit. The charges made for the outstanding loan portfolio are credited to the allowance for loan losses, whereas charges for off-balance sheet items are credited to the reserve for off-balance sheet items, which is presented as a component of other liabilities. The provision for loan losses is discussed in the section entitled "Provision for Loan Losses" above.

The balance of our allowance for loan losses is Management's best estimate of the remaining losses inherent in the portfolio. The ultimate adequacy of the allowance is dependent upon a variety of factors beyond our control, including the real estate market, changes in interest rate and economic and political environments.

Historically, over the past five years, due to the economic downturn's effect on the financial stability of certain borrowers, we set aside more reserves for probable loan losses. However, in 2012, amid signs of credit quality improvement, the allowance for loan losses decreased by 7.4%, or \$634,000, to \$7.98 million at December 31, 2012 as compared with \$8.61 million at December 31, 2011. Such allowances were \$8.25 million, \$7.02 million and \$5.57 million at December 31, 2010, 2009 and 2008, respectively. In 2012, the allowance for loan losses as a percentage of total loans decreased corresponding to our improved credit quality and lower non-accrual loan totals, as reflected in the ratios of 2.04%, 2.17%, 2.04%, 1.65% and 1.30%, at the end of 2012, 2011, 2010, 2009 and 2008, respectively. Based on the current conditions of the loan portfolio, management believes that the \$7.98 million allowance for loan losses at December 31, 2012 is adequate to absorb losses inherent in our loan portfolio. No assurance can be given, however, that adverse economic conditions or other circumstances will not result in increased losses in the portfolio.

Diversification, low loan-to-values, strong credit quality and enhanced credit monitoring contribute to a reduction in the portfolio's overall risk, and help to offset the economic risk. The impact of the stagnant economic environment will continue to be monitored, and adjustments to the provision for loan loss will be made accordingly. The weak business climate adversely impacted the financial conditions of some of our clients and resulted in net loan charge-offs of \$1,784,000, \$1,146,000, \$2,785,000, \$4,411,000, and \$1,110,000 in 2012, 2011, 2010, 2009 and 2008, respectively.

Management reviews these conditions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specific, identifiable problem credit or portfolio segment as of the evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the unallocated allowance. Although management has allocated a portion of the allowance to specific loan categories, the adequacy of the allowance is considered in its entirety.

Although management believes the allowance at December 31, 2012 was adequate to absorb losses from any known and inherent risks in the portfolio, no assurance can be given that economic conditions which adversely affect our service areas or other variables will not result in increased losses in the loan portfolio in the future.

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As of December 31, 2012, our allowance for loan losses consisted of amounts allocated to three phases of our methodology for assessing loan loss allowances, as follows (see details of methodology for assessing allowance for loan losses in the section entitled "Critical Accounting Policies"):

| Phase of Methodology (Dollars in Thousands)             | Years Ended December 31, |       |      |       |      |       |
|---|--------------------------|-------|------|-------|------|-------|
|   | 2012                     |       | 2011 |       | 2010 |       |
| Specific review of individual loans                     | \$                       | 549   | \$   | 551   | \$   | 948   |
| Review of pools of loans with similar characteristics   |                          | 5,521 |      | 6,091 |      | 5,392 |
| Judgmental estimate based on various subjective factors |                          | 1,905 |      | 1,967 |      | 1,915 |
|   | \$                       | 7,975 | \$   | 8,609 | \$   | 8,255 |

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*The Components of the Allowance for Loan Losses*

As stated previously in *Critical Accounting Policies*, the overall allowance consists of a specific allowance for individually identified impaired loans, an allowance factor for categories of credits with similar characteristics and trends, and an allowance for changing environmental factors.

The first component, the specific allowance, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Through Management's ongoing loan grading process, individual loans are identified that have conditions that indicate the borrower may be unable to pay all amounts due under the contractual terms. These loans are evaluated individually by Management and specified allowances for loan losses are established when the discounted cash flows of future payments or collateral value of collateral-dependent loans are lower than the recorded investment in the loan. Generally with problem credits that are collateral-dependent, we obtain appraisals of the collateral at least annually. We may obtain appraisals more frequently if we believe the collateral value is subject to market volatility, if a specific event has occurred to the collateral (e.g. tentative map has been filed), or if we believe foreclosure is imminent. Impaired loan balances decreased from \$7.2 million at December 31, 2011 to \$6.9 million at December 31, 2012. The specific allowance totaled \$549,000 and \$551,000 at December 31, 2012 and 2011, respectively, as we charge off substantially all of our estimated losses related to specifically identified impaired loans as the losses are identified.

The second component, the allowance factor, is an estimate of the probable inherent losses in each loan pool stratified by major categories or loans with similar characteristics in our loan portfolio. This analysis encompasses segmenting and reviewing loan grades by pool and current general economic and business conditions. Confirmation of the quality of our grading process is obtained by independent reviews conducted by consultants specifically hired for this purpose and by various bank regulatory agencies. This analysis covers our entire loan portfolio but excludes any loans that were analyzed individually for specific allowances as discussed above. There are limitations to any credit risk grading process. The number of loans makes it impractical to review every loan every quarter. Therefore, it is possible that in the future some currently performing loans not recently graded will not be as strong as their last grading and an insufficient portion of the allowance will have been allocated to them. Grading and loan review often must be done without knowing whether all relevant facts are at hand. Troubled borrowers may deliberately or inadvertently omit important information from reports or conversations with lending officers regarding their financial condition and the diminished strength of repayment sources.

The total amount allocated for the second component is determined by applying loss estimation factors to outstanding loans. At December 31, 2012 and 2011, the allowance allocated by categories of credits totaled \$5.5 million and \$6.1 million, respectively. The increase mainly related to increased allowance factors for land loans related to the construction of residential subdivisions, commercial quick-qualifier loans and manufactured home loans, recognizing increased risk for these types of loans, as well as loan growth.

The third component of the allowance for loan losses is an economic component that is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by portfolio trends, concentration of credit, growth, and economic trends, as stated previously in *Critical Accounting Policies*. At December 31, 2012 and 2011, the general valuation allowance, including the economic component, totaled \$1.9 million and \$2.0 million, respectively. Starting in late 2008, we witnessed financial difficulties experienced by borrowers in our market, where real estate sale prices have declined and holding periods have increased. The U.S. economy is still experiencing significantly reduced business activity as a result of, among other factors, disruptions in the financial system, dramatic declines in the housing prices, and an increasing unemployment rate. There have been significant reductions in spending by consumers and businesses. In response to this, we have been proactive in evaluating reserve percentages for economic and other qualitative loss factors used to determine the adequacy of the allowance for loan losses. The increase to the third component of the allowance for loan losses reflected such evaluation.



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The table below summarizes, for the periods indicated, loan balances at the end of each period, the daily averages during the period, changes in the allowance for loan losses arising from loans charged off, recoveries on loans previously charged off, additions to the allowance and certain ratios related to the allowance for loan losses:

**Allowance for Loan Losses**

(in thousands)

|   | 2012       | 2011       | 2010       | 2009       | 2008       |
|---|------------|------------|------------|------------|------------|
| <b>Balances:</b>  |            |            |            |            |            |
| Average total loans outstanding during period                                   | \$ 390,856 | \$ 394,130 | \$ 411,590 | \$ 426,748 | \$ 400,821 |
| Total loans outstanding at end of period  | \$ 390,986 | \$ 396,202 | \$ 404,194 | \$ 425,627 | \$ 428,177 |
| <b>Allowance for loan losses:</b>   |            |            |            |            |            |
| <b>Balances at beginning of period</b>  | \$ 8,609   | \$ 8,255   | \$ 7,020   | \$ 5,569   | \$ 4,507   |
| <b>Actual charge-offs:</b>  |            |            |            |            |            |
| Commercial real estate  | 1,663      | 1,108      | 2,696      | 3,524      | 1,062      |
| Commercial and Industrial   | 0          | 44         | 52         | 871        | 11         |
| Consumer  | 26         | 7          | 1          | 0          | 0          |
| Consumer Residential  | 150        | 38         | 43         | 24         | 42         |
| Agriculture   | 0          | 0          | 0          | 0          | 0          |
| Total charge-offs   | 1,839      | 1,197      | 2,792      | 4,419      | 1,115      |
| <b>Recoveries on loans previously charged off:</b>                              |            |            |            |            |            |
| Commercial real estate  | 35         | 30         | 0          | 0          | 0          |
| Commercial and Industrial   | 1          | 14         | 2          | 0          | 0          |
| Consumer  | 4          | 6          | 5          | 0          | 0          |
| Consumer Residential  | 15         | 1          | 0          | 8          | 5          |
| Agriculture   | 0          | 0          | 0          | 0          | 0          |
| Total recoveries  | 55         | 51         | 7          | 8          | 5          |
| Net loan charge-offs/(recoveries)   | 1,784      | 1,146      | 2,785      | 4,411      | 1,110      |
| Provision for loan losses   | 1,150      | 1,500      | 4,020      | 5,862      | 2,188      |
| Reclassification of reserve related to off-balance-sheet commitments            | 0          | 0          | 0          | 0          | (16)       |
| Balance at end of period  | \$ 7,975   | \$ 8,609   | \$ 8,255   | \$ 7,020   | \$ 5,569   |
| <b>Ratios:</b>  |            |            |            |            |            |
| Net loan charge-offs/(recoveries) to average total loans                        | 0.46%      | 0.29%      | 0.68%      | 1.03%      | 0.28%      |
| Allowance for loan losses to total loans at end of period                       | 2.04%      | 2.17%      | 2.04%      | 1.65%      | 1.30%      |
| Net loan charge-offs (recoveries) to allowance for loan losses at end of period | 22.37%     | 13.31%     | 33.74%     | 62.83%     | 19.93%     |
| Net loan charge-offs (recoveries) to provision for loan losses                  | 155.13%    | 76.40%     | 69.28%     | 75.25%     | 50.73%     |



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The table below summarizes the allowance for loan loss balance by type of loan balance at the end of each period (See Loan Portfolio above for a description of each type of loan balance):

**Allocation of the Allowance for Loan Losses**

|                           | Amount Outstanding as of December 31, |                 |                 |                 |                 | 2008 |
|---------------------------|---------------------------------------|-----------------|-----------------|-----------------|-----------------|------|
|                           | 2012                                  | 2011            | 2010            | 2009            | 2008            |      |
|                           | (Dollars in Thousands)                |                 |                 |                 |                 |      |
| <b>Applicable to:</b>     |                                       |                 |                 |                 |                 |      |
| Commercial real estate    | \$ 6,571                              | \$ 6,969        | \$ 6,577        | \$ 5,845        | \$ 4,364        |      |
| Commercial and Industrial | 474                                   | 606             | 686             | 649             | 732             |      |
| Consumer                  | 50                                    | 65              | 61              | 44              | 34              |      |
| Consumer Residential      | 384                                   | 348             | 375             | 202             | 193             |      |
| Agriculture               | 286                                   | 363             | 153             | 142             | 127             |      |
| Unallocated               | 210                                   | 258             | 403             | 138             | 119             |      |
| <b>Total Allowance</b>    | <b>\$ 7,975</b>                       | <b>\$ 8,609</b> | <b>\$ 8,255</b> | <b>\$ 7,020</b> | <b>\$ 5,569</b> |      |

**Other Earning Assets**

For various business purposes, we make investments in earning assets other than the interest-earning securities discussed above. Before 2007, the only other earning assets held by us were insignificant amounts of Federal Home Loan Bank stock, Federal Reserve Bank stock and the cash surrender value on the Company Owned Life Insurances ( BOLI ).

During 2007, we invested in a low-income housing tax credit funds ( LIHTCF ) to promote our participation in CRA activities. We committed to invest \$1 million over a three year period, which was fully funded by the year 2009. We receive the return in the form of tax credits and tax deductions which began in 2007 and are expected to continue through the year 2022. The \$1 million contribution is being amortized to other expenses over a term of 15 years, commensurate with the benefits received.

The balances of other earning assets as of December 31, 2012 and December 31, 2011 were as follows:

| Dollars in Thousands         | Balance as of     |        | Balance as of     |        |
|------------------------------|-------------------|--------|-------------------|--------|
| Type                         | December 31, 2012 |        | December 31, 2011 |        |
| BOLI                         | \$                | 11,680 | \$                | 11,256 |
| LIHTCF                       | \$                | 575    | \$                | 636    |
| Federal Reserve Bank Stock   | \$                | 758    | \$                | 1,162  |
| Federal Home Loan Bank Stock | \$                | 2,372  | \$                | 2,832  |

**Deposits and Other Sources of Funds**

*Deposits*

Total deposits at December 31, 2012, and 2011 were \$587.0 million, and \$536.2 million, respectively, representing an increase of \$50.8 million or 9.5% in 2012. The average deposits for the years ended December 31, 2012 increased \$41.1 million or 8.3% to \$537.0 million compared to \$495.9 million at December 31, 2011.

Deposits are the Company's primary source of funds. Due to strategic emphasis by management, core deposits (based on definition provided by FDIC's Uniform Bank Performance Report) increased by 9.4% in 2012 to \$574.5 million at December 31, 2012. The percentage of core deposits to total deposits remained flat at 97.9% at December 31, 2012 as compared to 98.0% at December 31, 2011. The average rate paid on time deposits in denominations of \$100,000 or more was 0.86% and 1.01% for the years ended December 31, 2012 and 2011, respectively. The composition and cost of the Company's deposit base are important



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components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. See "Net Interest Income and Net Interest Margin" for further discussion.

The Company's liquidity is impacted by the volatility of deposits or other funding instruments or, in other words, by the propensity of that money to leave the institution for rate-related or other reasons. Deposits can be adversely affected if economic conditions in California and the Company's market area in particular, continue to weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed \$100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

The following tables summarize the distribution of average daily deposits and the average daily rates paid for the periods indicated:

**Distribution of Average Daily Deposits**

(Dollars in Thousands)

| Dollars in Thousands                              | 2012            |              | 2011            |              | 2010            |              |
|---|-----------------|--------------|-----------------|--------------|-----------------|--------------|
|   | Average Balance | Average Rate | Average Balance | Average Rate | Average Balance | Average Rate |
| Demand  | \$ 133,674      | 0.00%        | \$ 101,599      | 0.00%        | \$ 76,820       | 0.00%        |
| Money market                                      | 249,652         | 0.21%        | 245,815         | 0.31%        | 212,621         | 0.65%        |
| NOW   | 68,454          | 0.15%        | 66,157          | 0.20%        | 59,617          | 0.31%        |
| Savings   | 26,238          | 0.22%        | 18,389          | 0.35%        | 14,963          | 0.42%        |
| Time certificates of deposit of \$100,000 or more | 37,150          | 0.86%        | 35,172          | 1.01%        | 42,352          | 1.20%        |
| Other time deposits                               | 21,822          | 0.61%        | 28,755          | 0.90%        | 33,383          | 1.37%        |
| Total deposits                                    | \$ 536,990      | 0.21%        | \$ 495,887      | 0.32%        | \$ 439,756      | 0.58%        |

The scheduled maturities of our time deposits in denominations of \$100,000 or greater at December 31, 2012 are, as follows:

**Maturities of Time Deposits of \$100,000 or More**

(Dollars in Thousands)

|                                       |           |
|---------------------------------------|-----------|
| Three months or less                  | \$ 8,346  |
| Over three months through six months  | 15,413    |
| Over six months through twelve months | 6,864     |
| Over twelve months                    | 7,322     |
| Total                                 | \$ 37,945 |

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Because our client base is comprised primarily of commercial and industrial accounts, individual account balances are generally higher than those of consumer-oriented banks. Eight of our clients carry deposit balances of more than 1% of our total deposits, two of which had a deposit balance of more than 3% of total deposits at December 31, 2012.

The Company had \$2.0 million and \$1.4 million in brokered deposits as of December 31, 2012 and 2011, respectively. The only brokered deposits the Company holds are from CDARS and ICS, a certificate of deposit and money market account program, respectively, that exchanges funds with other network banks to offer full FDIC insurance coverage to the customer.

Table of Contents*FHLB Borrowings*

Although deposits are the primary source of funds for our lending and investment activities and for general business purposes, we may obtain advances from the Federal Home Loan Bank of San Francisco ( FHLB ) as an alternative to retail deposit funds. Our outstanding FHLB advances were fully paid off at year-end 2012 compared to \$3.0 million outstanding as of year-end 2011. See Liquidity Management below for the details on the FHLB borrowings program.

The following table is a summary of FHLB borrowings for fiscal years 2012 and 2011:

| <b>Dollars in Thousands</b>                 | <b>2012</b> |       | <b>2011</b> |       |
|---|-------------|-------|-------------|-------|
| Balance at year-end                         | \$          | 0     | \$          | 3,000 |
| Average balance during the year             | \$          | 467   | \$          | 6,479 |
| Maximum amount outstanding at any month-end | \$          | 3,000 | \$          | 8,000 |
| Average interest rate during the year       |             | 0.99% |             | 1.05% |
| Average interest rate at year-end           |             | 0.00% |             | 0.99% |

**Return on Equity and Assets**

The following table sets forth certain information regarding our return on equity and assets for the periods indicated:

|                                 | <b>At December 31, 2012</b> | <b>At December 31, 2011</b> |
|---------------------------------|-----------------------------|-----------------------------|
| Return on average assets        | 0.95%                       | 1.02%                       |
| Return on average common equity | 8.80%                       | 8.67%                       |
| Dividend payout ratio           | 0.00%                       | 0.00%                       |
| Equity to assets ratio          | 10.59%                      | 11.50%                      |

**Deferred Compensation Obligations**

We maintain a nonqualified, unfunded deferred compensation plan for certain key management personnel. Under this plan, participating employees may defer compensation, which will entitle them to receive certain payments upon retirement, death, or disability. The plan provides for payments commencing upon retirement and reduced benefits upon early retirement, disability, or termination of employment. At December 31, 2012 and 2011, our aggregate payment obligations under this plan totaled \$7.4 million and \$7.4 million, respectively.

**Off-Balance Sheet Arrangements**

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

As of December 31, 2012, and 2011, we had commitments to extend credit of \$42.2 million and \$46.4 million, respectively. Obligations under standby letters of credit were \$0.5 million and \$0.6 million, for 2012, and 2011, respectively, and there were no obligations under commercial letters of credit for either period.

The effect on our revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will be used. For more information regarding our off balance sheet arrangements, see Note 15- Commitments and Other Contingencies- to our 2012 year-end consolidated financial statements located elsewhere in this report.

Table of Contents**Contractual Obligations**

The following chart summarizes certain contractual obligations of the Company as of December 31, 2012 (dollars in thousands):

| <b>Contractual Obligations</b> | <b>Less than 1<br/>Year</b> | <b>1-3 years</b> | <b>3-5 years</b> | <b>More than 5<br/>years</b> | <b>Total</b>     |
|--------------------------------|-----------------------------|------------------|------------------|------------------------------|------------------|
| Operating lease obligations    | \$ 869                      | \$ 1,501         | \$ 858           | \$ 1,623                     | \$ 4,851         |
| Supplemental retirement plans  | 19                          | 144              | 264              | 1,373                        | 1,800            |
| Time deposit maturities        | 37,836                      | 18,739           | 1,791            | 0                            | 58,366           |
| <b>Total</b>                   | <b>\$ 38,724</b>            | <b>\$ 20,384</b> | <b>\$ 2,913</b>  | <b>\$ 2,996</b>              | <b>\$ 65,017</b> |

As permitted or required under California law and to the maximum extent allowable under that law, we have certain obligations to indemnify our current and former officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. We also have the obligation to similarly indemnify our current and former officers. These indemnification obligations are valid as long as the director or officer acted in good faith and in a manner the person reasonably believed to be in, or not opposed to, our best interests, and with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful. The maximum potential amount of future payments we could be required to make under these indemnification obligations is unlimited; however, we have a director and officer insurance policy that mitigates our exposure and enables us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification obligations is minimal.

**Liquidity and Asset/Liability Management**

Management seeks to ascertain optimum and stable utilization of available assets and liabilities as a vehicle to attain our overall business plans and objectives. In this regard, management focuses on measurement and control of liquidity risk, interest rate risk and market risk, capital adequacy, operation risk and credit risk.

**Liquidity**

Liquidity to meet borrowers' credit and depositors' withdrawal demands is provided by maturing assets, short-term liquid assets that can be converted to cash and the ability to attract funds from depositors. Additional sources of liquidity may include institutional deposits, advances from the FHLB and other short-term borrowings, such as federal funds purchased.

Since our deposit growth strategy emphasizes core deposit growth we have avoided relying on brokered deposits as a consistent source of funds. The only brokered deposit the Company holds are from CDARS and ICS, a certificate of deposit and money market program, respectively, that exchanges funds with other network banks to offer full FDIC insurance coverage to the customer. The Company had \$2.0 million and \$1.4 million in brokered deposits as of December 31, 2012 and 2011, respectively.

As a secondary source of liquidity, we rely on advances from the FHLB to supplement our supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB are typically secured by a portion of our loan portfolio and stock issued by the FHLB. The FHLB determines limitations on the amount of advances by assigning a percentage to each eligible loan category that will count towards the borrowing capacity. At December 31, 2012, the Company had no FHLB advances outstanding as compared to \$3.0 million at December 31, 2011, which equaled 2% of our borrowing capacity. At December 31, 2012 and December 31, 2011, the Company had sufficient collateral to borrow an additional \$163.4 million and \$130.3 million, respectively. In addition, the Company had lines of credit with its correspondent banks to purchase overnight federal funds totaling \$25 million at December 31, 2012 and 2011. No advances were made on these lines of credit as of December 31, 2012 and December 31, 2011.

The Company's liquidity depends primarily on dividends paid to it as sole shareholder of the Bank. The Bank's ability to pay dividends to the Company will depend on whether the Bank will be in a position to pay dividends based on regulatory requirements and the performance of the Bank.

Maintenance of adequate liquidity requires that sufficient resources be available at all time to meet our cash flow requirements. Liquidity in a banking institution is required primarily to provide for deposit withdrawals and the credit needs of its customers and to take advantage of investment opportunities as they arise. Liquidity management involves our ability to convert assets into cash or cash equivalents without incurring significant loss, and to raise cash or maintain funds without incurring excessive additional cost. For this purpose, we maintain a portion of our funds in cash and cash equivalents, loans and securities available for

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sale. Our liquid assets at December 31, 2012 and 2011 totaled approximately \$200.1 million and \$153.4 million, respectively. Our liquidity level measured as the percentage of liquid assets to total assets was 30.3% and 25.1% at December 31, 2012, and 2011, respectively.

***Capital Resources and Capital Adequacy Requirements***

In the past two years, our primary source of capital has been internally generated operating income through retained earnings. At December 31, 2012, total shareholders' equity decreased to \$70.0 million, representing a decrease of \$433,000 from December 31, 2011. The decrease was due to the \$6.75 million redemption of SBLF preferred stock as described below, which was offset by the increase in retained earnings.

In December 2008, the Company was selected to participate in the U.S. Treasury Capital Purchase Program which demonstrated the confidence the U.S. Treasury Department has in the stability of the Company. The Company issued \$13.5 million in Series A preferred stock. In August 2011, the Company repurchased these Series A preferred stock shares and simultaneously issued \$13,500,000 in Series B Preferred Stock to the U.S. Treasury under the Small Business Lending Funding ( SBLF ) program. Subsequently, the Company fully redeemed a warrant to purchase 350,346 shares of its Common Stock, at the exercise price of \$5.78 per share that the Company had granted to the U.S. Treasury pursuant to the TCPP, for a purchase price of \$560,000, which settled in September 2011. In May 2012, the Company repurchased from the U.S. Treasury 6,750 shares of Series B Preferred Stock for aggregate consideration of \$6.75 million. Thereafter, in March 2013, the Company repurchased from the U.S. Treasury the remaining 6,750 shares of Series B Preferred Stock for aggregate consideration of \$6,817,500, reflecting \$6,750,000 paid for the repurchase, and \$67,500 paid for accrued dividends. The securities issued to the Treasury were accounted for as components of regulatory Tier 1 capital. See Notes 3 and 24 to the Consolidated Financial Statements in Item 8 of this report for further discussion regarding our participation in the TCPP and SBLF.

As of December 31, 2012, we had no material commitments for capital expenditures other than the Series B Preferred Stock dividend payments due to the U.S. Treasury under the SBLF program.

We are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can trigger regulatory actions that could have a material adverse effect on our financial statements and operations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that rely on quantitative measures of our assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. (See Description of Business-Regulation and Supervision-Capital Adequacy Requirements herein for exact definitions and regulatory capital requirements.)

As of December 31, 2012, we were qualified as a well-capitalized institution under the regulatory framework for prompt corrective action. The following table presents the regulatory standards for well-capitalized institutions, compared to the Bank's capital ratios as of the dates specified:

|  | <b>Regulatory Well-<br/>Capitalized Standards</b> | <b>December 31, 2012</b> | <b>December 31, 2011</b> |
|--|---|--------------------------|--------------------------|
| Total capital to risk-weighted assets  | 10.0%   | 16.0%                    | 16.2%                    |
| Tier I capital to risk-weighted assets | 6.0%  | 14.8%                    | 14.9%                    |

|                                  |      |       |       |
|----------------------------------|------|-------|-------|
| Tier I capital to average assets | 5.0% | 10.3% | 11.4% |
|----------------------------------|------|-------|-------|

**Market Risk**

Market risk is the risk of loss of future earnings, fair values, or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributed to all market risk sensitive financial instruments, including securities, loans, deposits and borrowings, as well as the Company's role as a financial intermediary in customer-related transactions. The objective of market risk management is to avoid excessive exposure of the Company's earnings and equity to loss and to reduce the volatility inherent in certain financial instruments.



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**Interest Rate Management**

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments, nor does the Company have exposure to currency exchange rates.

The principal objective of interest rate risk management (often referred to as asset/liability management) is to manage the financial components of the Company in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage the risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity gap report may not provide a complete assessment of the exposure to changes in interest rates.

The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down) and ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or stable economic conditions (unchanged from current actual levels).

The Company applies a market value (MV) methodology to gauge its interest rate risk exposure as derived from its simulation model. Generally, MV is the discounted present value of the difference between incoming cash flows on interest-earning assets and other investments and outgoing cash flows on interest-bearing liabilities and other liabilities. The application of the methodology attempts to quantify interest rate risk as the change in the MV which would result from a theoretical 200 basis point (1 basis point equals 0.01%) change in market interest rates. Both a 200 basis point increase and a 200 basis point decrease in market rates are considered.

At December 31, 2012, it was estimated that the Company's MV would decrease 19.01% in the event of an immediate 200 basis point increase in market interest rates. The Company's MV at the same date would decrease 2.79% in the event of an immediate 200 basis point decrease in applicable interest rates.

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Presented below, as of December 31, 2012 and 2011, is an analysis of the Company's interest rate risk as measured by changes in MV for instantaneous and sustained parallel shifts of applicable interest rates:

| Shock Scenario | December 31, 2012         |                          |   |                         | December 31, 2011         |                          |   |                         |
|----------------|---------------------------|--------------------------|---|-------------------------|---------------------------|--------------------------|---|-------------------------|
|                | \$ Change in Market Value | % Change in Market Value | Market Value as a % of Present Value of Assets MV Ratio | % of Assets Change (bp) | \$ Change in Market Value | % Change in Market Value | Market Value as a % of Present Value of Assets MV Ratio | % of Assets Change (bp) |
| +200 bp        | \$ (13,843)               | (19.01)%                 | 9.18%   | (159)                   | \$ (12,150)               | (15.46)%                 | 11.14%  | (141)                   |
| +100 bp        | \$ (7,963)                | (10.93)%                 | 9.86%   | (91)                    | \$ (6,692)                | (8.52)%                  | 11.80%  | (75)                    |
| 0 bp           | \$ 0                      | 0.00%                    | 10.77%  | 0                       | \$ 0                      | 0.00%                    | 12.55%  | 0                       |
| -100 bp        | \$ 6,845                  | 9.40%                    | 11.51%  | 74                      | \$ 9,306                  | 11.84%                   | 13.70%  | 115                     |
| -200 bp        | \$ (2,034)                | (2.79)%                  | 10.28%  | (49)                    | \$ 2,813                  | 3.58%                    | 12.70%  | 15                      |

Management believes that the MV methodology overcomes three shortcomings of the typical maturity gap methodology. First, it does not use arbitrary repricing intervals and accounts for all expected future cash flows. Second, because the MV method projects cash flows of each financial instrument under different interest rate environments, it can incorporate the effect of embedded options on an institution's interest rate risk exposure. Third, it allows interest rates on different instruments to change by varying amounts in response to a change in market interest rates, resulting in more accurate estimates of cash flows.

However, as with any method of gauging interest rate risk, there are certain shortcomings inherent to the MV methodology. The model assumes interest rate changes are instantaneous parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short-term and long-term rates change by the same degree may also misstate historic rate patterns, which rarely show parallel yield curve shifts. Further, the model assumes that certain assets and liabilities of similar maturity or period to repricing will react in the same way to changes in rates. In reality, certain types of financial instruments may react in advance of changes in market rates, while the reaction of other types of financial instruments may lag behind the change in general market rates. When interest rates change, actual loan prepayments and actual early withdrawals from certificates may deviate significantly from the assumptions used in the model. Finally, this methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan clients' ability to service their debt. All of these factors are considered in monitoring the Company's exposure to interest rate risk.

**Impact of Inflation; Seasonality**

Inflation primarily impacts us by its effect on interest rates. Our primary source of income is net interest income, which is affected by changes in interest rates. We attempt to limit the impact of inflation on our net interest margin through management of rate-sensitive assets and liabilities and the analysis of interest rate sensitivity. The effect of inflation on premises and equipment as well as noninterest expenses has not been significant for the periods covered in this report. Our business is generally not seasonal.

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**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Not required.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our consolidated financial statements and the Independent Auditors Report appear on pages F-1 through F-43 of this Report and are incorporated into this Item 8 by reference.

**INDEX TO FINANCIAL STATEMENTS**

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| <b><u>REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM</u></b>              | F-2         |
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**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

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We conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act of 1934 (the "Act")) as of December 31, 2012. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2012.

The term disclosure controls and procedures means controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Act is accumulated and communicated to our Management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There are inherent limitations to the effectiveness of any system of disclosure controls and procedures. These limitations include the possibility of human error, the circumvention or overriding of the controls and procedures and reasonable resource constraints. In addition, because we have designed our system of controls based on certain assumptions, which we believe are reasonable, about the likelihood of future events, our system of controls may not achieve its desired purpose under all possible future conditions. Accordingly, our disclosure controls and procedures provide reasonable assurance, but not absolute assurance, of achieving their objectives.

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***Management's Annual Report on Internal Control over Financial Reporting***

Our Management's report on Internal Control over Financial Reporting is set forth in Item 8 and is incorporated herein by reference.

Our internal control over financial reporting is designed to provide reasonable, but not absolute, assurance regarding the financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles. There are inherent limitations to the effectiveness of any system of internal control over financial reporting. These limitations include the possibility of human error, the circumvention of overriding of the system and reasonable resource constraints. Because of its inherent limitations, our internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

***Changes in Internal Control over Financial Reporting***

There was no change in our internal control over financial reporting that occurred during the quarter ended December 31, 2012 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

Table of Contents**PART III****ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this Item is incorporated by reference from our Proxy Statement to be filed prior to the 2013 Annual Meeting of Shareholders. The Company and the Company have adopted a Code of Ethics that applies to all staff including the Chief Executive Officer, and the Chief Financial Officer. A copy of the Code of Ethics will be provided to any person, without charge, upon written request to Corporate Secretary, Oak Valley Bancorp, 125 North Third Avenue, Oakdale, CA 95361.

**Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's officers and directors, and persons who own more than 10% of a registered class of the Company's equity securities, to file reports of ownership and changes in ownership with the FDIC. Officers, directors and greater than 10% shareholders are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file.

Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons that no Forms 4 and 5 were required for those persons, the Company believes that for the 2012 fiscal year the officers and directors of the Company complied with all applicable filing requirements, except for the two directors named in the table below:

| Name           | Transaction Type | Transaction Date  | # of Shares |
|----------------|------------------|-------------------|-------------|
| Jay Gilbert    | Sold             | May 25, 2012      | 7,000       |
| Jay Gilbert    | Purchased        | November 15, 2012 | 2,587       |
| Jay Gilbert    | Purchased        | November 16, 2012 | 765         |
| Jay Gilbert    | Purchased        | November 19, 2012 | 1,757       |
| Jay Gilbert    | Sold             | November 19, 2012 | 3,095       |
| Jay Gilbert    | Purchased        | November 26, 2012 | 200         |
| Daniel Leonard | Purchased        | May 25, 2012      | 1,000       |
| Daniel Leonard | Purchased        | May 25, 2012      | 447         |

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this Item is incorporated by reference from our Proxy Statement to be filed prior to the 2013 Annual Meeting of Shareholders.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by this Item is incorporated by reference from our Proxy Statement to be filed prior to the 2013 Annual Meeting of Shareholders.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this Item is incorporated by reference from our Proxy Statement to be filed prior to the 2013 Annual Meeting of Shareholders.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by this Item is incorporated by reference from our Proxy Statement to be filed prior to the 2013 Annual Meeting of Shareholders.



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**PART IV**

**ITEM 15 EXHIBITS, FINANCIAL STATEMENT SCHEDULES**

Documents Filed as Part of this Report:

**(a)(1) Financial Statements**

The Financial Statements of the Company and the Report of Independent Registered Public Accounting Firm are set forth on pages F-1 through F-43.

**(a)(2) Financial Statement Schedules**

All schedules to the Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Financial Statements or accompanying notes.

**(a)(3) Exhibits**

The exhibit list required by this Item is incorporated by reference to the Exhibit Index included in this report. The warranties, representations and covenants contained in any of the agreements included herein or which appear as exhibits hereto should not be relied upon by buyers, sellers or holders of the Company's securities and are not intended as warranties, representations or covenants to any individual or entity except as specifically set forth in such agreement

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Oakdale, California on March 28, 2013.

**OAK VALLEY BANCORP**  
a California corporation

By: */s/ RONALD C. MARTIN*  
Ronald C. Martin, *Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

**POWER OF ATTORNEY**

KNOW ALL MEN BY THESE PRESENTS, that each of the undersigned officers and directors of the registrant hereby constitutes and appoints Ronald C. Martin and Richard A. McCarty, and each of them, as lawful attorney-in-fact and agent for each of the undersigned (with full power of substitution and resubstitution, for and in the name, place and stead of each of the undersigned officers and directors), to sign and file with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, any and all amendments, supplements and exhibits to this report and any and all other documents in connection therewith, hereby granting unto said attorneys-in-fact, and each of them, full power and authority to do and perform each and every act and thing necessary or desirable to be done in order to effectuate the same as fully and to all intents and purposes as each of the undersigned might or could do if personally present, hereby ratifying and confirming all that said attorneys-in-fact and agents, or any of them, or any of their substitutes, may do or cause to be done by virtue hereof.

| <b>Signature</b>  | <b>Title</b> | <b>Date</b>    |
|---|--------------|----------------|
| <i>/s/ DONALD BARTON</i><br>Donald Barton                     | Director     | March 26, 2013 |
| <i>/s/ CHRISTOPHER M. COURTNEY</i><br>Christopher M. Courtney | Director     | March 26, 2013 |
| <i>/s/ JAMES L. GILBERT</i><br>James L. Gilbert               | Director     | March 26, 2013 |
| <i>/s/ THOMAS A. HAIDLEN</i><br>Thomas A. Haidlen             | Director     | March 26, 2013 |
| <i>/s/ MICHAEL Q. JONES</i><br>Michael Q. Jones               | Director     | March 26, 2013 |

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|  |          |                |
|--|----------|----------------|
| /s/ DANIEL J. LEONARD<br>Daniel J. Leonard   | Director | March 26, 2013 |
| /s/ RONALD C. MARTIN<br>Ronald C. Martin     | Director | March 26, 2013 |
| /s/ ROGER M. SCHRIMP<br>Roger M. Schrimp     | Director | March 26, 2013 |
| /s/ DANNY L. TITUS<br>Danny L. Titus         | Director | March 26, 2013 |
| /s/ RICHARD J. VAUGHAN<br>Richard J. Vaughan | Director | March 26, 2013 |

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**MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

As of December 31, 2012, management assessed the effectiveness of the Company's internal control over financial reporting based on the criteria for effective internal control over financial reporting established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and guidance issued by the Securities and Exchange Commission. Based on the assessment, management determined that the Company maintained effective internal control over financial reporting as of December 31, 2012, based on those criteria.

The Company's management, including its Chief Executive Officer and Chief Financial Officer, does not expect that its disclosure controls and procedures, or its internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected.

/s/ RONALD C. MARTIN  
Ronald C. Martin, *Chief Executive Officer*

/s/ RICHARD A. MCCARTY  
Richard A. McCarty, *Chief Financial Officer*

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders

Oak Valley Bancorp

We have audited the accompanying consolidated balance sheets of Oak Valley Bancorp and subsidiary (the Company) as of December 31, 2012 and 2011 and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the years ended December 31, 2012 and 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Oak Valley Bancorp and subsidiary as of December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for the years ended December 31, 2012 and 2011 in conformity with accounting principles generally accepted in the United States of America.

/s/ Moss Adams LLP

Stockton, California

March 28, 2013

Table of Contents**OAK VALLEY BANCORP****CONSOLIDATED BALANCE SHEETS**

|  | December 31,<br>2012 | December 31,<br>2011 |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| Cash and due from banks  | \$ 130,799,998       | \$ 73,189,775        |
| Federal funds sold   | 10,535,000           | 27,895,000           |
| Cash and cash equivalents  | 141,334,998          | 101,084,775          |
| Securities available for sale  | 103,865,881          | 89,694,859           |
| Loans, net of allowance for loan loss of \$7,974,975 and \$8,609,174 at December 31, 2012 and 2011, respectively   | 382,411,361          | 386,958,076          |
| Bank premises and equipment, net   | 13,182,451           | 13,499,285           |
| Other real estate owned  | 0                    | 244,375              |
| Interest receivable and other assets   | 19,786,065           | 20,690,288           |
|  | \$ 660,580,756       | \$ 612,171,658       |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                      |                      |
| Deposits   | \$ 586,992,650       | \$ 536,204,003       |
| Federal Home Loan Bank advances  | 0                    | 3,000,000            |
| Interest payable and other liabilities   | 3,619,382            | 2,565,649            |
| Total liabilities  | 590,612,032          | 541,769,652          |
| Commitments and contingencies  |                      |                      |
| Shareholders' equity   |                      |                      |
| Series B Preferred stock, no par value; \$1,000 per share liquidation preference, 10,000,000 shares authorized, 6,750 and 13,500 shares issued and outstanding at December 31, 2012 and 2011, respectively | 6,750,000            | 13,500,000           |
| Common stock, no par value; 50,000,000 shares authorized, 7,907,780 and 7,718,469 shares issued and outstanding at December 31, 2012 and 2011, respectively  | 23,673,210           | 23,453,443           |
| Additional paid-in capital   | 2,341,814            | 2,128,700            |
| Retained earnings  | 33,958,737           | 28,629,757           |
| Accumulated other comprehensive income, net of tax   | 3,244,963            | 2,690,106            |
| Total shareholders' equity   | 69,968,724           | 70,402,006           |
|  | \$ 660,580,756       | \$ 612,171,658       |

See accompanying notes

Table of Contents**OAK VALLEY BANCORP****CONSOLIDATED STATEMENTS OF INCOME**

|   | <b>YEAR ENDED DECEMBER 31,</b> |                     |
|---|--------------------------------|---------------------|
|   | <b>2012</b>                    | <b>2011</b>         |
| <b>INTEREST INCOME</b>                              |                                |                     |
| Interest and fees on loans                          | \$ 22,449,274                  | \$ 23,608,833       |
| Interest on securities available for sale           | 3,368,924                      | 3,076,575           |
| Interest on federal funds sold                      | 28,565                         | 41,884              |
| Interest on deposits with banks                     | 135,260                        | 100,249             |
| Total interest income                               | 25,982,023                     | 26,827,541          |
| <b>INTEREST EXPENSE</b>                             |                                |                     |
| Deposits  | 1,132,513                      | 1,579,877           |
| FHLB advances                                       | 4,707                          | 68,081              |
| Federal funds purchased                             |                                | 51                  |
| Total interest expense                              | 1,137,220                      | 1,648,009           |
| Net interest income                                 | 24,844,803                     | 25,179,532          |
| <b>PROVISION FOR LOAN LOSSES</b>                    | <b>1,150,000</b>               | <b>1,500,000</b>    |
| Net interest income after provision for loan losses | 23,694,803                     | 23,679,532          |
| <b>OTHER INCOME</b>                                 |                                |                     |
| Service charges on deposits                         | 1,173,088                      | 1,120,035           |
| Earnings on cash surrender value of life insurance  | 423,757                        | 432,234             |
| Mortgage commissions                                | 239,538                        | 103,935             |
| Other   | 1,312,294                      | 1,094,930           |
| Total non-interest income                           | 3,148,677                      | 2,751,134           |
| <b>OTHER EXPENSES</b>                               |                                |                     |
| Salaries and employee benefits                      | 10,008,829                     | 9,325,812           |
| Occupancy expenses                                  | 2,947,769                      | 2,829,468           |
| Data processing fees                                | 1,128,377                      | 1,016,132           |
| OREO expenses                                       | 26,949                         | 389,124             |
| Regulatory assessments (FDIC & DFI)                 | 461,000                        | 642,000             |
| Other operating expenses                            | 3,675,545                      | 3,191,229           |
| Total non-interest expense                          | 18,248,469                     | 17,393,765          |
| Net income before provision for income taxes        | 8,595,011                      | 9,036,901           |
| <b>PROVISION FOR INCOME TAXES</b>                   | <b>2,814,156</b>               | <b>3,176,306</b>    |
| <b>NET INCOME</b>                                   | <b>\$ 5,780,855</b>            | <b>\$ 5,860,595</b> |
| Preferred stock dividends and accretion             | 451,875                        | 1,161,056           |
| <b>NET INCOME AVAILABLE TO COMMON SHAREHOLDERS</b>  | <b>\$ 5,328,980</b>            | <b>\$ 4,699,539</b> |
| <b>NET INCOME PER COMMON SHARE</b>                  | <b>\$ 0.69</b>                 | <b>\$ 0.61</b>      |
| <b>NET INCOME PER DILUTED COMMON SHARE</b>          | <b>\$ 0.69</b>                 | <b>\$ 0.61</b>      |

*See accompanying notes*

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Table of Contents**OAK VALLEY BANCORP****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

|  | <b>YEAR ENDED DECEMBER 31,</b> |              |
|--|--------------------------------|--------------|
|  | <b>2012</b>                    | <b>2011</b>  |
| Net income   | \$ 5,780,855                   | \$ 5,860,595 |
| Available for sale securities:                               |                                |              |
| Gross unrealized gain arising during the year                | 1,034,532                      | 2,029,446    |
| Reclassification adjustment for gains realized in net income | (91,700)                       | (81,184)     |
| Income tax expense   | (387,975)                      | (801,710)    |
| Other comprehensive income                                   | 554,857                        | 1,146,552    |
| Comprehensive income   | \$ 6,335,712                   | \$ 7,007,147 |

*See accompanying notes*

Table of Contents**OAK VALLEY BANCORP****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

|  | YEARS ENDED DECEMBER 31, 2011 AND 2012 |                        |                           |                           |                                  |                      |   |                                 |
|--|--|------------------------|---------------------------|---------------------------|----------------------------------|----------------------|---|---------------------------------|
|  | Common Stock<br>Shares                 | Common Stock<br>Amount | Preferred Stock<br>Shares | Preferred Stock<br>Amount | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Shareholders<br>Equity |
| Balances, January 1,<br>2011                   | 7,702,127                              | \$ 24,003,549          | 13,500                    | \$ 13,013,945             | \$ 2,080,218                     | \$ 24,016,466        | \$ 1,543,554                                    | \$ 64,657,732                   |
| Stock options exercised                        | 3,037                                  | \$ 9,894               |                           |                           |                                  |                      |   | \$ 9,894                        |
| Restricted stock issued                        | 13,305                                 |                        |                           |                           |                                  |                      |   |                                 |
| Repurchase of Series A<br>preferred stock      |  |                        | (13,500)                  | \$ (13,500,000)           |                                  |                      |   | (13,500,000)                    |
| Series B preferred stock<br>issued             |  |                        | 13,500                    | 13,500,000                |                                  |                      |   | 13,500,000                      |
| Preferred stock accretion                      |  |                        |                           | 486,055                   |                                  | \$ (486,055)         |   | 0                               |
| Preferred stock dividend<br>payments           |  |                        |                           |                           |                                  | (761,249)            |   | (761,249)                       |
| Payment to repurchase<br>U.S. Treasury Warrant |  | (560,000)              |                           |                           |                                  |                      |   | (560,000)                       |
| Stock based<br>compensation                    |  |                        |                           |                           | 48,482                           |                      |   | 48,482                          |
| Other comprehensive<br>income                  |  |                        |                           |                           |                                  |                      | 1,146,552                                       | 1,146,552                       |
| Net income                                     |  |                        |                           |                           |                                  | 5,860,595            |   | 5,860,595                       |
| Balances, December 31,<br>2011                 | 7,718,469                              | \$ 23,453,443          | 13,500                    | \$ 13,500,000             | \$ 2,128,700                     | \$ 28,629,757        | \$ 2,690,106                                    | \$ 70,402,006                   |
| Stock options exercised                        | 54,436                                 | \$ 219,767             |                           |                           |                                  |                      |   | \$ 219,767                      |
| Tax benefit on stock<br>options exercised      |  |                        |                           |                           | 37,218                           |                      |   | 37,218                          |
| Restricted stock issued                        | 134,875                                |                        |                           |                           |                                  |                      |   |                                 |
| Repurchase of Series B<br>preferred stock      |  |                        | (6,750)                   | \$ (6,750,000)            |                                  |                      |   | (6,750,000)                     |
| Preferred stock dividend<br>payments           |  |                        |                           |                           |                                  | (451,875)            |   | (451,875)                       |
| Stock based<br>compensation                    |  |                        |                           |                           | 175,896                          |                      |   | 175,896                         |
| Other comprehensive<br>income                  |  |                        |                           |                           |                                  |                      | 554,857   | 554,857                         |
| Net income                                     |  |                        |                           |                           |                                  | 5,780,855            |   | 5,780,855                       |
| Balances, December 31,<br>2012                 | 7,907,780                              | \$ 23,673,210          | 6,750                     | \$ 6,750,000              | \$ 2,341,814                     | \$ 33,958,737        | \$ 3,244,963                                    | \$ 69,968,724                   |

*See accompanying notes*



Table of Contents**OAK VALLEY BANCORP****CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | <b>YEARS ENDED DECEMBER 31,</b> |                   |
|--|---------------------------------|-------------------|
|  | <b>2012</b>                     | <b>2011</b>       |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                                 |                   |
| Net income   | \$ 5,780,855                    | \$ 5,860,595      |
| Adjustments to reconcile net earnings to net cash from operating activities:             |                                 |                   |
| Provision for loan losses  | 1,150,000                       | 1,500,000         |
| Decrease in deferred fees/costs, net   | (34,582)                        | (98,579)          |
| Depreciation   | 1,138,185                       | 998,014           |
| Amortization of investment securities, net   | 241,862                         | 36,407            |
| Stock based compensation   | 175,896                         | 48,482            |
| Excess tax benefits from stock-based payment arrangements                                | (37,218)                        | 0                 |
| Gain on sale of premises and equipment   | (22,498)                        | 0                 |
| OREO write downs and (gain)/losses on sale   | (3,548)                         | 290,609           |
| Gain on called available for sale securities   | (91,700)                        | (81,184)          |
| Earnings on cash surrender value of life insurance                                       | (423,757)                       | (432,234)         |
| (Increase) decrease in deferred tax asset  | (100,825)                       | 205,224           |
| Increase (decrease) in interest payable and other liabilities                            | 1,053,733                       | (434,187)         |
| Decrease (increase) in interest receivable   | 48,983                          | (61,595)          |
| Decrease in other assets   | 165,015                         | 2,283,773         |
| Net cash from operating activities   | 9,040,401                       | 10,115,325        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                                 |                   |
| Purchases of available for sale securities   | (43,742,857)                    | (54,574,719)      |
| Proceeds from maturities, calls, and principal paydowns of securities available for sale | 30,364,505                      | 20,140,881        |
| Net decrease in loans  | 3,431,297                       | 6,846,711         |
| Purchase of FRB Stock  | (1,450)                         | (2,450)           |
| Redemption of FRB Stock  | 405,000                         | 0                 |
| Redemption of FHLB stock   | 460,500                         | 548,600           |
| Proceeds from sale of OREO   | 247,923                         | 243,190           |
| Proceeds from sales of premises and equipment  | 22,498                          | 450               |
| Net purchases of premises and equipment  | (821,351)                       | (4,323,927)       |
| Net cash (used in) investing activities  | (9,633,935)                     | (31,121,264)      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                                 |                   |
| FHLB payments  | (3,000,000)                     | (5,000,000)       |
| Repurchase of Series A Preferred Stock   | 0                               | (13,500,000)      |
| Proceeds from Series B Preferred Stock issued  | 0                               | 13,500,000        |
| Preferred stock dividend payment   | (451,875)                       | (761,249)         |
| Payment to repurchase U.S. Treasury Warrant  | 0                               | (560,000)         |
| Repurchase of Series B preferred stock   | (6,750,000)                     | 0                 |
| Net increase in demand deposits and savings accounts                                     | 52,690,752                      | 72,401,862        |
| Net decrease in time deposits  | (1,902,105)                     | (12,936,709)      |
| Excess tax benefits from stock-based payment arrangements                                | 37,218                          | 0                 |
| Proceeds from sale of common stock and exercise of stock options                         | 219,767                         | 9,894             |
| Net cash from financing activities   | 40,843,757                      | 53,153,798        |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>   | <b>40,250,223</b>               | <b>32,147,859</b> |
| <b>CASH AND CASH EQUIVALENTS, beginning of period</b>                                    | <b>101,084,775</b>              | <b>68,936,916</b> |

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|  |    |             |    |             |
|--|----|-------------|----|-------------|
| CASH AND CASH EQUIVALENTS, end of period | \$ | 141,334,998 | \$ | 101,084,775 |
|--|----|-------------|----|-------------|

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the period for:

|              |    |           |    |           |
|--------------|----|-----------|----|-----------|
| Interest     | \$ | 1,198,534 | \$ | 1,686,014 |
| Income taxes | \$ | 1,745,000 | \$ | 3,961,119 |

NON-CASH INVESTING ACTIVITIES:

|  |    |         |    |           |
|--|----|---------|----|-----------|
| Change in unrealized gain on available-for-sale securities | \$ | 942,832 | \$ | 1,948,262 |
|--|----|---------|----|-----------|

NON-CASH FINANCING ACTIVITIES:

|                              |    |   |    |         |
|------------------------------|----|---|----|---------|
| Accretion of preferred stock | \$ | 0 | \$ | 486,055 |
|------------------------------|----|---|----|---------|

*See accompanying notes*

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**OAK VALLEY BANCORP**

**NOTES TO FINANCIAL STATEMENTS**

**NOTE 1 SUMMARY OF ACCOUNTING POLICIES**

**Introductory Explanation**

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

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

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

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

A summary of the significant accounting policies applied in the preparation of the accompanying consolidated financial statements follows.

**Cash and cash equivalents** The Company has defined cash and cash equivalents to include cash, due from banks, certificates of deposit with maturities of three months or less, and federal funds sold. Generally, federal funds are sold for one-day periods. At times throughout the year, balances can exceed FDIC insurance limits. Management believes the risk of loss is remote as these amounts are held by major financial institutions and management monitors their financial condition.

**Securities available for sale** Available-for-sale securities consist of bonds, notes, and debentures not classified as trading securities or held-to-maturity securities. Available-for-sale securities with unrealized holding gains and losses, net of tax, are reported as a net amount in a separate component of shareholders' equity, accumulated other comprehensive income, until realized. Gains and losses on the sale of available-for-sale securities are determined using the specific identification method. The amortization of premiums and accretion of discounts are recognized as adjustments to interest income over the period to maturity.

Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate investments, from rising interest rates. At each consolidated financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other than temporary. This assessment includes a determination of whether the Company intends to sell the security, or if it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other than temporarily impaired and that the Company does not intend to sell and will not be required to sell prior to recovery of the amortized cost basis, the amount of impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is calculated as the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of the future expected cash flows is deemed to be due to factors that are not credit related and is recognized in other comprehensive income.

**Other real estate owned** Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value of the property at the date of foreclosure less estimated selling costs. Subsequent to foreclosure, valuations are

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periodically performed and any subject revisions in the estimate of fair value are reported as adjustment to the carrying value of the real estate, provided the adjusted carrying amount does not exceed the original amount at foreclosure. Revenues and expenses from operations and changes in the valuation allowance are included in other operating expenses.

**Loans and allowance for loan losses** Loans are reported at the principal amount outstanding, net of unearned income, deferred loan fees, and the allowance for loan losses. Unearned discounts on installment loans are recognized as income over the terms of the loans. Interest on other loans is calculated by using the simple interest method on the daily balance of the principal amount outstanding.

Loan fees net of certain direct costs of origination are deferred and amortized, as an adjustment to interest yield, over the estimated life of the loan.

Loans on which the accrual of interest has been discontinued are designated as non-accrual loans. Accrual of interest on loans is discontinued either when reasonable doubt exists as to the full and timely collection of interest or principal or when a loan becomes contractually past due by ninety days or more with respect to interest or principal. When a loan is placed on non-accrual status, all interest previously accrued, but not collected, is reversed against current period interest income. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

The allowance for loan losses is established through a provision for loan losses charged to operations. Loans are charged against the allowance for loan losses when management believes that the collectability of the principal is unlikely. Subsequent recoveries of previously charged off amounts, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based on management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additional allowance based on their judgment about information available to them at the time of their examination.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as impaired. Impaired loans, as defined, are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. The general component relates to non-impaired loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.



The Company considers a loan impaired when it is probable that all amounts of principal and interest due, according to the contractual terms of the loan agreement, will not be collected. Interest income is recognized on impaired loans in the same manner as non-accrual loans. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

The method for calculating the allowance for unfunded loan commitments is based on an allowance percentage which is less than other outstanding loan types because they are at a lower risk level. This allowance percentage is evaluated by management periodically and is applied to the total undisbursed loan commitment balance to calculate the allowance for off-balance-sheet commitments.

The Company considers a loan to be a troubled debt restructure ( TDR ) when the Company has granted a concession and the borrower is experiencing financial difficulty. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's internal underwriting policy. A TDR loan is kept on

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non-accrual status until the borrower has paid for six consecutive months with no payment defaults, at which time the TDR is placed back on accrual status.

**Premises and equipment** Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives using the straight-line basis. The estimated lives used in determining depreciation are:

|                        |        |       |
|------------------------|--------|-------|
| Building               | 31.5   | years |
| Equipment              | 3 - 12 | years |
| Furniture and fixtures | 3 - 7  | years |
| Leasehold improvements | 5 - 15 | years |
| Automobiles            | 3 - 5  | years |

Leasehold improvements are amortized over the lesser of the useful life of the asset or the remaining term of the lease. The straight-line method of depreciation is followed for all assets for financial reporting purposes, but accelerated methods are used for tax purposes. Deferred income taxes have been provided for the resulting temporary differences.

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

The Company files income tax returns in the U.S. federal jurisdiction, and the state of California. With few exceptions, the Company is no longer subject to U.S. federal or state/local income tax examinations by tax authorities for years before 2008.

**Transfers of financial assets** Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that contain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Advertising costs** The Company expenses marketing costs as they are incurred. Advertising expense was \$166,000 and \$160,000 for the years ended December 31, 2012 and 2011, respectively.

**Comprehensive income** Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes items previously recorded directly to equity, such as unrealized gains and losses on securities available for sale. Comprehensive income is presented in the statements of comprehensive income and as a component of shareholders' equity. For the years ended December 31, 2012 and 2011, \$54,000 and \$48,000 net of tax, respectively, was reclassified from comprehensive income into net income related to gains on called available for sale securities.

**Investment in limited partnership** During 2007 the Company acquired limited interests in a private limited partnership that acquires affordable housing properties in California that generate Low Income Housing Tax Credits under Section 42 of the Internal Revenue Code of 1986, as amended. The Company's limited partnership investment is accounted for under the equity method. The Company's noninterest expense associated with the utilization of these tax credits for the year ended December 31, 2012 and 2011 was \$64,000 and \$67,000, respectively. The limited partnership investment is expected to generate a total tax benefit of approximately \$1.16 million over the life of the investment for the combination of the tax credits and deductions on noninterest expense. The tax credits expire between 2013 and 2022. In 2011, a tax benefit of \$98,000 was utilized for income tax purposes and an estimated amount of \$90,000 will be utilized in 2012. The recorded investment in limited partnerships totaled \$575,000 and \$636,000 at December 31, 2012 and 2011, respectively, and is reflected as a component of interest receivable and other assets on the consolidated balance sheets.

**Federal Reserve Bank Stock** Federal Reserve Bank stock represents the Company's investment in the stock of the Federal Reserve Bank (FRB) and is carried at par value, which reasonably approximates its fair value. While technically these are considered equity securities, there is no market for the FRB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates FRB stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any

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decline in net assets of the FRB as compared to the capital stock amount for the FRB and the length of time this situation has persisted, (2) commitments by the FRB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FRB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FRB, and (4) the liquidity position of the FRB. This investment is reflected as a component of interest receivable and other assets on the consolidated balance sheets.

**Federal Home Loan Bank Stock** Federal Home Loan Bank stock represents the Company's investment in the stock of the Federal Home Loan Bank of San Francisco ( FHLB ) and is carried at par value, which reasonably approximates its fair value. While technically these are considered equity securities, there is no market for the FHLB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates FHLB stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB. This investment is reflected as a component of interest receivable and other assets on the consolidated balance sheets.

**Earnings per share ( EPS )** EPS is based upon the weighted average number of common shares outstanding during each year. The table in footnote 14 shows: (1) weighted average basic shares, (2) effect of dilutive securities related to stock options and non-vested restricted stock, and (3) weighted average diluted shares. Net income available to common shareholders is calculated as net income reduced by dividends accumulated on preferred stock. Basic EPS are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average diluted shares. The total dilutive shares included in annual diluted EPS is a year-to-date weighted average of the total dilutive shares included in each quarterly diluted EPS computation under the treasury stock method. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of restricted stock awards receive non-forfeitable dividends at the same rate as common stockholders and they both share equally in undistributed earnings.

**Stock based compensation** The Company recognizes in the consolidated statements of income the grant-date fair value of stock options and other equity-based forms of compensation issued to employees over the employees' requisite service period (generally the vesting period). The Company uses the straight-line recognition of expenses for awards with graded vesting.

The fair value of each option grant is estimated as of the grant date using a binomial option-pricing model for all grants. Expected volatility is based on the historical volatility of the price of the Company's stock. The Company uses historical data to estimate option exercise and stock option forfeiture rates within the valuation model. The expected term of options granted for the binomial model is derived from applying a historical suboptimal exercise factor to the contractual term of the grant. For binomial pricing, the risk-free rate for periods is equal to the U.S. Treasury yield at the time of grant and commensurate with the contractual term of the grant. There were no stock options granted in 2012 or 2011.

The fair value of restricted stock awards is based on the price of the Company's stock at the date of grant. There were 139,375 and 13,305 shares of restricted stock granted during 2012 and 2011, respectively. Stock based compensation recorded during the years ended December 31, 2012 and 2011 totaled approximately \$176,000 and \$48,000, respectively.

**Fair values of financial instruments** The consolidated financial statements include various estimated fair value information as of December 31, 2012 and 2011. Such information, which pertains to the Company's financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change.

**Fair Value Measurements** The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The Company bases the fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Securities available for sale, derivatives, and loans held for sale, if any, are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record certain assets at fair value on a non-recurring basis, such as certain impaired loans held for investment and securities held to maturity that are other-than-temporarily impaired. These non-recurring fair value adjustments typically involve write-downs of individual assets due to application of lower-of-cost or market accounting.

The Company has established and documented a process for determining fair value. The Company maximizes the use of observable inputs and minimizes the use of unobservable inputs when developing fair value measurements. Whenever there is no readily

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available market data, Management uses its best estimate and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these financial consolidated statements.

**Deferred compensations plans** Future compensation under the Company's executive salary continuation plan and director retirement plan is earned for services rendered through retirement. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Company's current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 20 years.

**Reclassifications** Certain prior year amounts have been reclassified to conform to the current year presentation. There was no effect on net income or shareholders' equity as a result of reclassifications.

**Recently Issued Accounting Standards**

In May 2011, the FASB issued ASU No. 2011-04 Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The ASU improves the comparability of fair value measurements presented and disclosed in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs) by changing the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and disclosure of information. The amendments to this ASU provide explanation on how to measure fair value but do not require any additional fair value measurements and does not establish valuation standards or affect valuation practices outside of financial reporting. The amendments clarify existing fair value measurements and disclosure requirements to include application of the highest and best use and valuation premises concepts; measuring fair value of an instrument classified in a reporting entity's shareholders' equity; and disclosures requirements regarding quantitative information about unobservable inputs categorized within Level 3 of the fair value hierarchy. In addition, clarification is provided for measuring the fair value of financial instruments that are managed in a portfolio and the application of premiums and discounts in a fair value measurement. For public entities, ASU 2011-04 is effective during interim and annual periods beginning after December 15, 2011. There was no significant impact on the Company's financial position or results of operations as a result of adopting this ASU.

In June 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-05 Comprehensive Income (Topic 220) Presentation of Comprehensive Income. The ASU improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. The amendments to Topic 220, Comprehensive Income, require entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Entities are no longer permitted to present components of other comprehensive income as part of the statement of changes in stockholders' equity. Any adjustments for items that are reclassified from other comprehensive income to net income are to be presented on the face of the entities financial statement regardless the method of presentation for comprehensive income. The amendments do not change items to be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do the amendments change the option to present the components of other comprehensive income either net of related tax effects or before related tax effects. ASU 2011-05 is effective for fiscal years, and interim periods beginning on or after December 15, 2011. The Company adopted this ASU in the first quarter of 2012.

In December 2011, the FASB issued ASU No. 2011-11, Disclosures about Offsetting Assets and Liabilities. The update requires an entity to offset, and present as a single net amount, a recognized eligible asset and a recognized eligible liability when it has an unconditional and legally

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enforceable right of setoff and intends either to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously. The ASU requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued ASU No. 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The Update clarifies that ASU 2011-11 applies only to derivatives, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset or subject to an enforceable master netting arrangement or similar agreement. Entities with other types of financial assets and financial liabilities subject to a master netting arrangement or similar agreement are no longer subject to the disclosure requirements in ASU 2011-11. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company

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is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The Update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

**NOTE 2 CASH AND DUE FROM BANKS**

Cash and due from banks includes balances with the Federal Reserve Bank and other correspondent banks. The Company is required to maintain specified reserves by the Federal Reserve Bank. The average reserve requirements are based on a percentage of the Company's deposit liabilities. In addition, the Federal Reserve Bank requires the Company to maintain a certain minimum balance at all times. As of December 31, 2012 the Company had a balance of \$85,133,000 which is more than adequate to satisfy the reserve requirement.

**NOTE 3 PREFERRED STOCK REPURCHASE AND WARRANT REDEMPTION**

In August 2011, the Company repurchased the \$13,500,000 of Series A Preferred Stock originally issued to the U.S. Treasury in December 2008 in connection with the Company's participation in the Capital Purchase Program ( CPP ). The Company simultaneously issued \$13,500,000 in Series B Preferred Stock to the U.S. Treasury under the Small Business Lending Funding ( SBLF ) program. Subsequently, the Company fully redeemed a warrant to purchase 350,346 shares of its Common Stock, at the exercise price of \$5.78 per share that the Company had granted to the U.S. Treasury pursuant to the CPP, for a purchase price of \$560,000, which settled in September 2011. So long as the preferred stock remains outstanding under SBLF, it will pay quarterly cumulative dividends at a variable rate between 1% and 5% per year for the first 2.5 years depending on growth of our small business loan portfolio. If there is no loan growth after 2.5 years, the dividend rate could increase to 7% and if the preferred stock remains outstanding after 4.5 years, the rate increases to 9%, regardless of loan growth.

The repurchase of the original preferred stock shares under CPP resulted in preferred stock discount accretion of \$389,000, the full remaining balance of the preferred stock discount at the time of the repurchase. This entry was recorded in the third quarter of 2011 and is reflected in the *Preferred stock dividends and accretion* line on the consolidated statements of income.

In May 2012, the Company repurchased from the U.S. Treasury 6,750 shares of Series B Preferred Stock for aggregate consideration of \$6.75 million.





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The amortized cost and estimated fair values of debt securities as of December 31, 2012, are as follows:

|                                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Market<br>Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|----------------------|
| Available-for-sale securities:      |                   |                              |                               |                      |
| U.S. agencies                       | \$ 52,607,537     | \$ 2,949,355                 | \$ (39,833)                   | \$ 55,517,059        |
| Collateralized mortgage obligations | 11,698,399        | 905,985                      |                               | 12,604,384           |
| Municipalities                      | 25,323,157        | 1,727,206                    | (58,075)                      | 26,992,288           |
| SBA Pools                           | 1,178,242         | 86                           | (20)                          | 1,178,308            |
| Corporate debt                      | 4,669,390         | 37,048                       | (836)                         | 4,705,602            |
| Mutual Fund                         | 2,874,727         |                              | (6,487)                       | 2,868,240            |
|                                     | \$ 98,351,452     | \$ 5,619,680                 | \$ (105,251)                  | \$ 103,865,881       |

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2012.

| Description of Securities             | Less than 12 months |                    | 12 months or more |                    | Total         |                    |
|---------------------------------------|---------------------|--------------------|-------------------|--------------------|---------------|--------------------|
|                                       | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| U.S. agencies                         | \$ 1,954,005        | \$ (39,833)        | \$                | \$                 | \$ 1,954,005  | \$ (39,833)        |
| Collateralized mortgage obligations   |                     |                    |                   |                    |               |                    |
| Municipalities                        | 3,088,970           | (58,075)           |                   |                    | 3,088,970     | (58,075)           |
| SBA Pools                             |                     |                    | 294,889           | (20)               | 294,889       | (20)               |
| Corporate debt                        | 749,164             | (836)              |                   |                    | 749,164       | (836)              |
| Mutual Fund                           | 2,493,512           | (6,487)            |                   |                    | 2,493,512     | (6,487)            |
| Total temporarily impaired securities | \$ 8,285,651        | \$ (105,231)       | \$ 294,889        | \$ (20)            | \$ 8,580,540  | \$ (105,251)       |

At December 31, 2012, one SBA pool was the only security in an unrealized loss position for greater than 12 months, and one U.S. agency, five municipalities, one corporate debt and one mutual fund security make up the total amount of securities in an unrealized loss position for less than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security's fair value. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Bank does not intend to sell the securities and it is not likely that we will be required to sell the securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

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The amortized cost and estimated fair value of debt securities at December 31, 2012, by contractual maturity or call date, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | Amortized<br>Cost | Fair<br>Value  |
|--|-------------------|----------------|
| <b>Available-for-sale securities:</b>  |                   |                |
| Due in one year or less                | \$ 11,068,417     | \$ 11,062,890  |
| Due after one year through five years  | 17,097,942        | 19,556,213     |
| Due after five years through ten years | 26,488,494        | 27,282,065     |
| Due after ten years                    | 43,696,599        | 45,964,713     |
|  | \$ 98,351,452     | \$ 103,865,881 |

The amortized cost and estimated fair values of debt securities as of December 31, 2011, are as follows:

|                                       | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Market<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|----------------------|
| <b>Available-for-sale securities:</b> |                   |                              |                               |                      |
| U.S. agencies                         | \$ 52,101,177     | 2,722,817                    | \$ (14,686)                   | \$ 54,809,308        |
| Collateralized mortgage obligations   | 11,366,368        | 728,104                      |                               | 12,094,472           |
| Municipalities                        | 15,660,035        | 1,312,377                    | (370)                         | 16,972,042           |
| SBA Pools                             | 1,236,366         | 55                           |                               | 1,236,421            |
| Corporate debt                        | 2,000,000         |                              | (185,716)                     | 1,814,284            |
| Mutual Fund                           | 2,759,316         | 9,016                        |                               | 2,768,332            |
|                                       | \$ 85,123,262     | \$ 4,772,369                 | \$ (200,772)                  | \$ 89,694,859        |

The following tables detail the gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2011.

| Description of Securities             | Less than 12 months |                    | 12 months or more |                    | Total         |                    |
|---------------------------------------|---------------------|--------------------|-------------------|--------------------|---------------|--------------------|
|                                       | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| U.S. agencies                         | \$ 2,985,314        | \$ (14,686)        | \$ 2,985,314      | \$ (14,686)        | \$ 2,985,314  | \$ (14,686)        |
| Municipalities                        | 561,580             | (370)              | 561,580           | (370)              | 561,580       | (370)              |
| Corporate debt                        | 1,814,284           | (185,716)          | 1,814,284         | (185,716)          | 1,814,284     | (185,716)          |
| Total temporarily impaired securities | \$ 5,361,178        | \$ (200,772)       | \$ 5,361,178      | \$ (200,772)       | \$ 5,361,178  | \$ (200,772)       |

At December 31, 2011, there were no securities in an unrealized loss position for greater than 12 months and one U.S. agency, one municipality and one corporate debt security make up the total amount of securities in an unrealized loss position for less than 12 months. Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other than temporary. This evaluation encompasses various factors including, the nature of the investment, the cause of the impairment, the severity and duration of the impairment, credit ratings and other credit related factors such as third party guarantees and volatility of the security's fair value. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due primarily to interest rate changes and the Bank does not intend to sell the securities and it is not likely that we will be required to sell the

securities before the earlier of the forecasted recovery or the maturity of the underlying investment security.

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Gross realized gains on called available-for-sale securities during 2012 and 2011 totaled \$91,700 and \$81,184, respectively. There were no losses on called available-for-sale securities realized during 2012 and 2011. There were no sales of available-for-sale securities during 2012 and 2011.

Securities carried at \$56,483,620 and \$53,419,019 at December 31, 2012 and 2011, respectively, were pledged to secure deposits of public funds.

### **NOTE 5 LOANS**

The Company's customers are primarily located in Stanislaus, San Joaquin, Tuolumne, Inyo, and Mono Counties. As of December 31, 2012, approximately 81% of the Company's loans are commercial real estate loans which includes construction loans. Approximately 9% of the Company's loans are for general commercial uses including professional, retail, and small business. Additionally, 7% of the Company's loans are for residential real estate and other consumer loans. The remaining 3% are agriculture loans.

Loan totals were as follows:

|                                      | YEAR ENDED DECEMBER 31, |                |
|--------------------------------------|-------------------------|----------------|
|                                      | 2012                    | 2011           |
| Commercial real estate:              |                         |                |
| Commercial real estate- construction | \$ 6,581,854            | \$ 14,595,324  |
| Commercial real estate- mortgages    | 278,766,279             | 284,263,685    |
| Land                                 | 14,269,477              | 10,635,954     |
| Farmland                             | 16,456,921              | 20,549,849     |
| Commercial and industrial            | 36,528,505              | 32,017,744     |
| Consumer                             | 1,095,801               | 1,212,986      |
| Consumer residential                 | 25,659,090              | 23,870,519     |
| Agriculture                          | 11,628,260              | 9,055,622      |
| Total loans                          | 390,986,187             | 396,201,683    |
| Less:                                |                         |                |
| Deferred loan fees and costs, net    | (599,851)               | (634,433)      |
| Allowance for loan losses            | (7,974,975)             | (8,609,174)    |
| Net loans                            | \$ 382,411,361          | \$ 386,958,076 |

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

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

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Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Company's commercial real estate portfolio are diverse in terms of type and geographic location. This diversity helps reduce the Company's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At December 31, 2012, approximately 35.8% of the outstanding principal balance of the Company's commercial real estate loans were secured by owner-occupied properties.

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

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

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

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

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Year-end non-accrual loans, segregated by class of loans, were as follows:

|                                      | YEAR ENDED DECEMBER 31, |              |
|--------------------------------------|-------------------------|--------------|
|                                      | 2012                    | 2011         |
| Commercial real estate:              |                         |              |
| Commercial real estate- construction | \$ 126,427              | \$ 179,262   |
| Commercial real estate- mortgages    | 3,345,098               | 3,671,693    |
| Land                                 | 2,419,223               | 3,277,463    |
| Farmland                             | 0                       | 0            |
| Commercial and industrial            | 21,311                  | 104,481      |
| Consumer                             | 0                       | 0            |
| Consumer residential                 | 1,010,998               | 0            |
| Agriculture                          | 0                       | 0            |
| Total non-accrual loans              | \$ 6,923,057            | \$ 7,232,899 |

Had non-accrual loans performed in accordance with their original contract terms, the Company would have recognized additional interest income of approximately \$696,000 in 2012 and \$692,000 in 2011.

The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of December 31, 2012:

|                                   | 30-59<br>Days Past<br>Due | 60-89<br>Days Past<br>Due | Greater<br>Than 90<br>Days Past<br>Due | Total Past<br>Due | Current        | Total          | Greater<br>Than 90<br>Days Past<br>Due and<br>Still<br>Accruing |
|-----------------------------------|---------------------------|---------------------------|--|-------------------|----------------|----------------|---|
| <b>December 31, 2012</b>          |                           |                           |  |                   |                |                |   |
| Commercial real estate:           |                           |                           |  |                   |                |                |   |
| Commercial R.E. -<br>construction | \$ 0                      | \$ 0                      | \$ 126,427                             | \$ 126,427        | \$ 6,455,427   | \$ 6,581,854   | \$ 0  |
| Commercial R.E. -<br>mortgages    | 55,089                    | 623,118                   | 2,386,688                              | 3,064,895         | 275,701,384    | 278,766,279    | 0   |
| Land                              | 0                         | 54,427                    | 2,364,797                              | 2,419,224         | 11,850,253     | 14,269,477     | 0   |
| Farmland                          | 0                         | 0                         | 0                                      | 0                 | 16,456,921     | 16,456,921     | 0   |
| Commercial and<br>industrial      | 16,138                    | 0                         | 0                                      | 16,138            | 36,512,367     | 36,528,505     | 0   |
| Consumer                          | 0                         | 0                         | 0                                      | 0                 | 1,095,801      | 1,095,801      | 0   |
| Consumer residential              | 0                         | 0                         | 1,010,998                              | 1,010,998         | 24,648,092     | 25,659,090     | 0   |
| Agriculture                       | 0                         | 0                         | 0                                      | 0                 | 11,628,260     | 11,628,260     | 0   |
| Total                             | \$ 71,227                 | \$ 677,545                | \$ 5,888,910                           | \$ 6,637,682      | \$ 384,348,505 | \$ 390,986,187 | \$ 0  |



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The following table analyzes past due loans including the non-accrual loans in the above table, segregated by class of loans, as of December 31, 2011:

|                                   | 30-59<br>Days Past<br>Due | 60-89<br>Days<br>Past Due | Greater<br>Than 90<br>Days Past<br>Due | Total Past<br>Due   | Current               | Total                 | Greater<br>Than 90<br>Days Past<br>Due and<br>Still<br>Accruing |
|-----------------------------------|---------------------------|---------------------------|--|---------------------|-----------------------|-----------------------|---|
| <b>December 31, 2011</b>          |                           |                           |  |                     |                       |                       |   |
| Commercial real estate:           |                           |                           |  |                     |                       |                       |   |
| Commercial R.E. -<br>construction | \$ 0                      | \$ 0                      | \$ 179,263                             | \$ 179,263          | \$ 14,416,061         | \$ 14,595,324         | 0   |
| Commercial R.E. -<br>mortgages    | 424,683                   | 0                         | 3,671,693                              | 4,096,376           | 280,167,309           | 284,263,685           | 0   |
| Land                              | 0                         | 0                         | 2,580,231                              | 2,580,231           | 8,055,723             | 10,635,954            | 0   |
| Farmland                          | 0                         | 0                         | 0                                      | 0                   | 20,549,849            | 20,549,849            | 0   |
| Commercial and<br>industrial      | 0                         | 79,059                    | 0                                      | 79,059              | 31,938,685            | 32,017,744            | 0   |
| Consumer                          | 16,419                    | 0                         | 0                                      | 16,419              | 1,196,567             | 1,212,986             | 0   |
| Consumer residential              | 0                         | 0                         | 0                                      | 0                   | 23,870,519            | 23,870,519            | 0   |
| Agriculture                       | 0                         | 0                         | 0                                      | 0                   | 9,055,622             | 9,055,622             | 0   |
| <b>Total</b>                      | <b>\$ 441,102</b>         | <b>\$ 79,059</b>          | <b>\$ 6,431,187</b>                    | <b>\$ 6,951,348</b> | <b>\$ 389,250,335</b> | <b>\$ 396,201,683</b> | <b>0</b>  |

*Impaired Loans.* Loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Impaired loans by class as of December 31, 2012 and 2011 are set forth in the following tables. No interest income was recognized on impaired loans subsequent to their classification as impaired during 2012 and 2011.

|                                   | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-----------------------------------|---|--|---|---------------------------------|----------------------|-----------------------------------|
| <b>December 31, 2012</b>          |   |  |   |                                 |                      |                                   |
| Commercial real estate:           |   |  |   |                                 |                      |                                   |
| Commercial R.E. -<br>construction | \$ 193,027                                    | \$ 0   | \$ 126,427                                  | \$ 126,427                      | \$ 2,872             | \$ 222,757                        |
| Commercial R.E. - mortgages       | 5,728,716                                     | 1,875,320                                      | 1,469,777                                   | 3,345,097                       | 136,015              | 3,093,523                         |
| Land                              | 6,866,869                                     | 663,232  | 1,755,991                                   | 2,419,223                       | 409,656              | 2,833,250                         |
| Farmland                          | 0   | 0  | 0   | 0                               | 0                    | 0                                 |
| Commercial and Industrial         | 27,812  | 21,311   | 0   | 21,311                          | 0                    | 52,822                            |
| Consumer                          | 0   | 0  | 0   | 0                               | 0                    | 0                                 |
| Consumer residential              | 1,034,884                                     | 1,010,999                                      | 0   | 1,010,999                       | 0                    | 534,578                           |

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|             |    |            |    |           |    |           |    |           |    |         |    |           |
|-------------|----|------------|----|-----------|----|-----------|----|-----------|----|---------|----|-----------|
| Agriculture |    | 0          |    | 0         |    | 0         |    | 0         |    | 0       |    | 0         |
| Total       | \$ | 13,851,308 | \$ | 3,570,862 | \$ | 3,352,195 | \$ | 6,923,057 | \$ | 548,543 | \$ | 6,736,930 |

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|                             | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-----------------------------|---|--|---|---------------------------------|----------------------|-----------------------------------|
| <b>December 31, 2011</b>    |   |  |   |                                 |                      |                                   |
| Commercial real estate:     |   |  |   |                                 |                      |                                   |
| Commercial R.E. -           |   |  |   |                                 |                      |                                   |
| construction                | \$ 245,862                                    | \$ 0   | \$ 179,262                                  | \$ 179,262                      | \$ 5,984             | \$ 1,177,407                      |
| Commercial R.E. - mortgages | 4,469,681                                     | 3,671,693                                      | 0   | 3,671,693                       | 0                    | 4,111,549                         |
| Land                        | 7,659,990                                     | 697,232  | 2,580,231                                   | 3,277,463                       | 544,630              | 3,329,784                         |
| Farmland                    | 0   | 0  | 0   | 0                               | 0                    | 0                                 |
| Commercial and Industrial   | 116,867                                       | 104,481  | 0   | 104,481                         | 0                    | 36,655                            |
| Consumer                    | 0   | 0  | 0   | 0                               | 0                    | 0                                 |
| Consumer residential        | 0   | 0  | 0   | 0                               | 0                    | 0                                 |
| Agriculture                 | 0   | 0  | 0   | 0                               | 0                    | 0                                 |
| <b>Total</b>                | <b>\$ 12,492,400</b>                          | <b>\$ 4,473,406</b>                            | <b>\$ 2,759,493</b>                         | <b>\$ 7,232,899</b>             | <b>\$ 550,614</b>    | <b>\$ 8,655,395</b>               |

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

At December 31, 2012, there were 6 loans and leases that were considered to be troubled debt restructurings, all of which are considered nonaccrual totaling \$2,567,000. At December 31, 2011, there were 5 loans and leases that were considered to be troubled debt restructurings, all of which are considered nonaccrual totaling \$3,482,000. At December 31, 2012 and 2011, there were unfunded commitments of \$1,697,000 and \$1,644,000, respectively, on one loan classified as a troubled debt restructure because of an agreement with a borrower to continue advancing funds and covering overhead costs on a residential development project. The Company will receive proceeds to pay down the principal as the residential properties sell.

During the year ended December 31, 2012, the terms of two loans were modified as troubled debt restructurings. During the year ended December 31, 2011, the terms of six loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date; or a temporary payment modification in which the payment amount allocated towards principal was reduced. In some cases, a permanent reduction of the accrued interest on the loan was conceded.

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The following table presents loans by class modified as troubled debt restructurings that occurred during the years ended December 31, 2012 and 2011:

|                                | Year Ended December 31, |   |   |                 |   |   |
|--------------------------------|-------------------------|---|---|-----------------|---|---|
|                                | Number of Loans         | 2012 Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Loans | 2011 Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Commercial real estate:        |                         |   |   |                 |   |   |
| Commercial R.E. - construction | 0                       | \$ 0  | \$ 0  | 2               | \$ 2,298,577  | \$ 2,298,577                                      |
| Commercial R.E. - mortgages    | 0                       | 0   | 0   | 0               | 0   | 0   |
| Land                           | 1                       | 58,261  | 58,261  | 3               | 3,328,512   | 3,328,512   |
| Farmland                       | 0                       | 0   | 0   | 0               | 0   | 0   |
| Commercial and Industrial      | 1                       | 23,111  | 23,111  | 1               | 26,322  | 26,322  |
| Consumer                       | 0                       | 0   | 0   | 0               | 0   | 0   |
| Consumer residential           | 0                       | 0   | 0   | 0               | 0   | 0   |
| Agriculture                    | 0                       | 0   | 0   | 0               | 0   | 0   |
| Total                          | 2                       | \$ 81,372   | \$ 81,372   | 6               | \$ 5,653,411  | \$ 5,653,411                                      |

The troubled debt restructurings during the years ended December 31, 2012 and 2011 did not increase the allowance for loan losses as a result of the loan modification and there were no charge offs as a result of the loan modifications.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the years ended December 31, 2012 and 2011.

|                                | Year Ended December 31, 2012 |                     | Year Ended December 31, 2011 |                     |
|--------------------------------|------------------------------|---------------------|------------------------------|---------------------|
|                                | Number of Loans              | Recorded Investment | Number of Loans              | Recorded Investment |
| Commercial real estate:        |                              |                     |                              |                     |
| Commercial R.E. - construction | 0                            | \$ 0                | 1                            | \$ 179,262          |
| Commercial R.E. - mortgages    | 0                            | 0                   | 0                            | 0                   |
| Land                           | 0                            | 0                   | 2                            | 2,580,231           |
| Farmland                       | 0                            | 0                   | 0                            | 0                   |
| Commercial and Industrial      | 0                            | 0                   | 0                            | 0                   |
| Consumer                       | 0                            | 0                   | 0                            | 0                   |
| Consumer residential           | 0                            | 0                   | 0                            | 0                   |
| Agriculture                    | 0                            | 0                   | 0                            | 0                   |
| Total                          | 0                            | \$ 0                | 3                            | \$ 2,759,493        |

A loan is considered to be in payment default once it is ninety days contractually past due under the modified terms.

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The troubled debt restructurings that subsequently defaulted above did not result in an increase to the allowance for loan losses or a charge-off during the years ended December 31, 2012 and 2011.

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

1 Exceptional Loan

2 Quality Loan

3A Better Than Acceptable Loan

3B Acceptable Loan

3C Marginally Acceptable Loan

4 (W) Watch Acceptable Loan

5 Other Loans Especially Mentioned

6 Substandard Loan

7 Doubtful Loan

8 Loss

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

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

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

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

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

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

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

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

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

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

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

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

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

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

7 Doubtful Loan - An extension of credit classified doubtful has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral or refinancing plans. The entire loan need not be classified doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the Company. In this situation, estimates are based on liquidation value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss. A credit classified as doubtful should be resolved within a reasonable period of time. Reasonable is generally defined as the period between examinations. In other words, a credit classified doubtful at an examination should be cleared up before the next exam. However, there may be situations that warrant continuation of the doubtful classification a while longer.



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

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

|                                       | December 31, 2012<br>Weighted Average<br>Risk Grade | December 31, 2011<br>Weighted Average<br>Risk Grade |
|---------------------------------------|---|---|
| <b>Commercial real estate:</b>        |   |   |
| Commercial real estate - construction | 3.23  | 3.52  |
| Commercial real estate - mortgages    | 3.22  | 3.26  |
| Land                                  | 4.56  | 4.75  |
| Farmland                              | 3.04  | 3.40  |
| Commercial and Industrial             | 3.09  | 3.21  |
| Consumer                              | 2.55  | 2.76  |
| Consumer residential                  | 3.17  | 3.10  |
| Agriculture                           | 3.50  | 3.23  |
| Total gross loans                     | 3.25  | 3.30  |

The following table presents risk grade totals by class of loans as of December 31, 2012 and 2011. Risk grades 1 through 4 have been aggregated in the Pass line.

| Dollars in thousands     | Commercial<br>R.E.<br>Construction | Commercial<br>R.E.<br>Mortgages | Land          | Farmland      | Commercial<br>and<br>Industrial | Consumer     | Consumer<br>Residential | Agriculture   | Total          |
|--------------------------|------------------------------------|---------------------------------|---------------|---------------|---------------------------------|--------------|-------------------------|---------------|----------------|
| <b>December 31, 2012</b> |                                    |                                 |               |               |                                 |              |                         |               |                |
| Pass                     | \$ 6,455,427                       | \$ 263,567,665                  | \$ 8,974,864  | \$ 16,456,921 | \$ 35,435,491                   | \$ 1,079,583 | \$ 24,257,465           | \$ 10,291,678 | \$ 366,519,094 |
| Special mention          |                                    | 7,832,840                       |               |               | 280,631                         |              |                         | 1,336,582     | 9,450,053      |
| Substandard              | 126,427                            | 7,365,774                       | 5,294,613     |               | 812,383                         | 16,218       | 1,401,625               |               | 15,017,040     |
| Doubtful                 |                                    |                                 |               |               |                                 |              |                         |               |                |
| Total loans              | \$ 6,581,854                       | \$ 278,766,279                  | \$ 14,269,477 | \$ 16,456,921 | \$ 36,528,505                   | \$ 1,095,801 | \$ 25,659,090           | \$ 11,628,260 | \$ 390,986,187 |
| <b>December 31, 2011</b> |                                    |                                 |               |               |                                 |              |                         |               |                |
| Pass                     | \$ 14,416,062                      | \$ 264,913,517                  | \$ 4,419,659  | \$ 19,188,322 | \$ 31,000,530                   | \$ 1,179,624 | \$ 23,475,447           | \$ 8,357,801  | \$ 366,950,962 |
| Special mention          |                                    | 8,684,736                       |               |               | 78,011                          |              |                         |               | 8,762,747      |
| Substandard              | 179,262                            | 10,665,432                      | 6,216,295     | 1,361,527     | 939,203                         | 16,943       | 395,072                 | 697,821       | 20,471,555     |
| Doubtful                 |                                    |                                 |               |               |                                 | 16,419       |                         |               | 16,419         |
| Total loans              | \$ 14,595,324                      | \$ 284,263,685                  | \$ 10,635,954 | \$ 20,549,849 | \$ 32,017,744                   | \$ 1,212,986 | \$ 23,870,519           | \$ 9,055,622  | \$ 396,201,683 |

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

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the

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current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including, among other things, the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Company's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

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

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

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

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

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



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The following table details activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2012 and 2011. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

**Allowance for Loan Losses****For the Years Ended December 31, 2012 and 2011**

|                                   | Commercial<br>Real Estate | Commercial<br>and Industrial | Consumer  | Consumer<br>Residential | Agriculture | Unallocated | Total        |
|-----------------------------------|---------------------------|------------------------------|-----------|-------------------------|-------------|-------------|--------------|
| <b><u>Year Ended December</u></b> |                           |                              |           |                         |             |             |              |
| <b><u>31, 2012</u></b>            |                           |                              |           |                         |             |             |              |
| Beginning balance                 | \$ 6,969,004              | \$ 606,307                   | \$ 65,060 | \$ 347,905              | \$ 363,174  | \$ 257,724  | \$ 8,609,174 |
| Charge-offs                       | (1,663,314)               | 0                            | (26,171)  | (149,897)               | 0           | 0           | (1,839,382)  |
| Recoveries                        | 35,407                    | 926                          | 3,840     | 15,010                  | 0           | 0           | 55,183       |
| Provision                         | 1,230,193                 | (133,506)                    | 7,333     | 170,635                 | (77,440)    | (47,215)    | 1,150,000    |
| Ending balance                    | \$ 6,571,290              | \$ 473,727                   | \$ 50,062 | \$ 383,653              | \$ 285,734  | \$ 210,509  | \$ 7,974,975 |
| <b><u>Year Ended December</u></b> |                           |                              |           |                         |             |             |              |
| <b><u>31, 2011</u></b>            |                           |                              |           |                         |             |             |              |
| Beginning balance                 | \$ 6,577,011              | \$ 686,303                   | \$ 61,115 | \$ 375,349              | \$ 152,526  | \$ 402,625  | \$ 8,254,929 |
| Charge-offs                       | (1,108,037)               | (43,784)                     | (6,559)   | (38,078)                | 0           | 0           | (1,196,458)  |
| Recoveries                        | 30,323                    | 14,121                       | 5,793     | 466                     | 0           | 0           | 50,703       |
| Provision                         | 1,469,707                 | (50,333)                     | 4,711     | 10,168                  | 210,648     | (144,901)   | 1,500,000    |
| Ending balance                    | \$ 6,969,004              | \$ 606,307                   | \$ 65,060 | \$ 347,905              | \$ 363,174  | \$ 257,724  | \$ 8,609,174 |

The following table details the allowance for loan losses and ending gross loan balances as of December 31, 2012 and 2011, summarized by collective and individual evaluation methods of impairment.

|                                       | Commercial<br>Real Estate | Commercial<br>and Industrial | Consumer     | Consumer<br>Residential | Agriculture   | Unallocated | Total          |
|---------------------------------------|---------------------------|------------------------------|--------------|-------------------------|---------------|-------------|----------------|
| <b><u>December 31, 2012</u></b>       |                           |                              |              |                         |               |             |                |
| Allowance for loan losses for loans:  |                           |                              |              |                         |               |             |                |
| Individually evaluated for impairment | \$ 548,543                | \$ 0                         | \$ 0         | \$ 0                    | \$ 0          | \$ 0        | \$ 548,543     |
| Collectively evaluated for impairment | 6,022,747                 | 473,727                      | 50,062       | 383,653                 | 285,734       | 210,509     | 7,426,432      |
|                                       | \$ 6,571,290              | \$ 473,727                   | \$ 50,062    | \$ 383,653              | \$ 285,734    | \$ 210,509  | \$ 7,974,975   |
| Ending gross loan balances:           |                           |                              |              |                         |               |             |                |
| Individually evaluated for impairment | \$ 5,890,748              | \$ 21,311                    | \$ 0         | \$ 1,010,998            | \$ 0          | \$ 0        | \$ 6,923,057   |
| Collectively evaluated for impairment | 310,183,783               | 36,507,194                   | 1,095,801    | 24,648,092              | 11,628,260    | 0           | 384,063,130    |
|                                       | \$ 316,074,531            | \$ 36,528,505                | \$ 1,095,801 | \$ 25,659,090           | \$ 11,628,260 | \$ 0        | \$ 390,986,187 |
| <b><u>December 31, 2011</u></b>       |                           |                              |              |                         |               |             |                |

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|                                       |    |             |    |            |    |           |    |            |    |           |    |         |    |             |
|---------------------------------------|----|-------------|----|------------|----|-----------|----|------------|----|-----------|----|---------|----|-------------|
| Allowance for loan losses for loans:  |    |             |    |            |    |           |    |            |    |           |    |         |    |             |
| Individually evaluated for impairment | \$ | 550,614     | \$ | 0          | \$ | 0         | \$ | 0          | \$ | 550,614   |    |         |    |             |
| Collectively evaluated for impairment |    | 6,418,390   |    | 606,307    |    | 65,060    |    | 347,905    |    | 363,174   |    | 257,724 |    | 8,058,560   |
|                                       | \$ | 6,969,004   | \$ | 606,307    | \$ | 65,060    | \$ | 347,905    | \$ | 363,174   | \$ | 257,724 | \$ | 8,609,174   |
| Ending balances of loans:             |    |             |    |            |    |           |    |            |    |           |    |         |    |             |
| Individually evaluated for impairment | \$ | 7,128,418   | \$ | 104,481    | \$ | 0         | \$ | 0          | \$ | 0         | \$ | 0       | \$ | 7,232,899   |
| Collectively evaluated for impairment |    | 322,916,394 |    | 31,913,263 |    | 1,212,986 |    | 23,870,519 |    | 9,055,622 |    | 0       |    | 388,968,784 |
|                                       | \$ | 330,044,812 | \$ | 32,017,744 | \$ | 1,212,986 | \$ | 23,870,519 | \$ | 9,055,622 | \$ | 0       | \$ | 396,201,683 |

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

|   | YEARS ENDED DECEMBER 31, |            |
|---|--------------------------|------------|
|   | 2012                     | 2011       |
| Balance, beginning of year                            | \$ 119,202               | \$ 157,001 |
| Provision Charged to Operations for Off Balance Sheet | (10,993)                 | (37,799)   |
| Balance, end of year                                  | \$ 108,209               | \$ 119,202 |

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

At December 31, 2012 and 2011, loans carried at \$390,986,187 and \$396,201,683, respectively, were pledged as collateral on advances from the Federal Home Loan Bank.

### **NOTE 6 PREMISES AND EQUIPMENT**

Major classifications of premises and equipment are summarized as follows:

|  | DECEMBER 31,  |               |
|--|---------------|---------------|
|  | 2012          | 2011          |
| Land   | \$ 4,698,703  | \$ 4,698,703  |
| Building                                       | 5,871,177     | 5,356,750     |
| Leasehold improvements                         | 4,239,294     | 3,993,247     |
| Furniture, fixtures, and equipment             | 8,081,698     | 8,105,152     |
|  | 22,890,872    | 22,153,852    |
| Less accumulated depreciation and amortization | (9,708,421)   | (8,654,567)   |
|  | \$ 13,182,451 | \$ 13,499,285 |

Depreciation expense was \$1,138,185 and \$998,014 for the years ended December 31, 2012 and 2011, respectively.

### **NOTE 7 INTEREST RECEIVABLE AND OTHER ASSETS**

Other assets are summarized as follows:



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|   | DECEMBER 31,  |               |
|---|---------------|---------------|
|   | 2012          | 2011          |
| Interest income receivable on loans       | \$ 1,202,181  | \$ 1,288,107  |
| Interest income receivable on investments | 452,293       | 415,350       |
| Net deferred tax asset                    | 1,670,290     | 1,957,440     |
| Federal Reserve Bank stock                | 758,150       | 1,161,700     |
| Federal Home Loan Bank stock              | 2,371,600     | 2,832,100     |
| Cash surrender value of life insurance    | 11,679,634    | 11,255,877    |
| Investment in limited partnership         | 575,090       | 636,099       |
| Prepaid expenses and other                | 1,076,827     | 1,143,615     |
|   | \$ 19,786,065 | \$ 20,690,288 |

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Deposit totals were as follows:

|                               | DECEMBER 31,   |                |
|-------------------------------|----------------|----------------|
|                               | 2012           | 2011           |
| Demand                        | \$ 175,588,439 | \$ 130,142,782 |
| NOW accounts                  | 83,861,123     | 72,867,073     |
| Money market deposit accounts | 238,996,864    | 254,011,364    |
| Savings                       | 30,180,677     | 18,915,132     |
| Time, under \$100,000         | 20,420,931     | 22,823,783     |
| Time, \$100,000 and over      | 37,944,616     | 37,443,869     |
| Total deposits                | \$ 586,992,650 | \$ 536,204,003 |

Certificates of deposit issued and their remaining maturities at December 31, 2012, are as follows:

| Year ending December 31, |      |               |
|--------------------------|------|---------------|
|                          | 2013 | \$ 37,836,890 |
|                          | 2014 | 9,631,638     |
|                          | 2015 | 9,106,322     |
|                          | 2016 | 621,459       |
|                          | 2017 | 1,169,238     |
|                          |      | \$ 58,365,547 |

**NOTE 9 FHLB ADVANCES**

At December 31, 2012, the Company had no outstanding advances from the Federal Home Loan Bank ( FHLB ). Unused and available advances totaled \$163,406,026 at December 31, 2012. Loans carried at \$390,986,187 as of December 31, 2012, were pledged as collateral on advances from the Federal Home Loan Bank.

At December 31, 2011, the Company had advances from the Federal Home Loan Bank ( FHLB ) totaling \$3,000,000. All of the total advances outstanding were term advances due in 2012, and there were no overnight open advances. The weighted average interest rate on these advances was 0.99% and interest payments are due monthly. Unused and available advances totaled \$130,291,562 at December 31, 2011. Loans carried at \$396,201,683 as of December 31, 2011, were pledged as collateral on advances from the Federal Home Loan Bank.

**NOTE 10 INTEREST ON DEPOSITS**

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Interest on deposits was comprised of the following:

|                                  | YEARS ENDED DECEMBER 31, |              |
|----------------------------------|--------------------------|--------------|
|                                  | 2012                     | 2011         |
| Savings and other deposits       | \$ 678,558               | \$ 963,926   |
| Time deposits \$100,000 and over | 321,832                  | 356,340      |
| Other time deposits              | 132,123                  | 259,611      |
|                                  | \$ 1,132,513             | \$ 1,579,877 |

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The provision for income taxes consists of the following:

|                 | YEARS ENDED DECEMBER 31, |              |
|-----------------|--------------------------|--------------|
|                 | 2012                     | 2011         |
| <b>Current</b>  |                          |              |
| Federal         | \$ 2,389,351             | \$ 2,356,017 |
| State           | 525,630                  | 615,065      |
|                 | 2,914,981                | 2,971,082    |
| <b>Deferred</b> |                          |              |
| Federal         | (87,789)                 | 260,546      |
| State           | (13,036)                 | (55,322)     |
|                 | (100,825)                | 205,224      |
|                 | \$ 2,814,156             | \$ 3,176,306 |

The components of the Company's deferred tax assets and liabilities (included in accrued interest and other assets on the consolidated balance sheets, is shown below:

|  | DECEMBER 31,        |                     |
|--|---------------------|---------------------|
|  | 2012                | 2011                |
| <b>Deferred tax assets:</b>                      |                     |                     |
| Deferred loan fees                               | \$ 92               | \$ 125              |
| Allowance for loan losses                        | 3,282,053           | 3,486,186           |
| Restricted stock expense                         | 63,416              | 5,037               |
| Accrued vacation                                 | 47,867              | 42,722              |
| Accrued salary continuation liability            | 740,983             | 622,043             |
| Deferred compensation                            | 102,166             | 87,489              |
| Nonaccrual loans                                 | 360,025             | 400,159             |
| Reserve for undisbursed commitments              | 44,533              | 49,057              |
| OREO expenses                                    | 240,687             | 150,590             |
| Checking cash rewards                            | 35,134              | 41,154              |
| State income tax                                 | 178,714             | 209,122             |
| Holding company organization fees                | 41,711              | 45,780              |
|  | 5,137,381           | 5,139,464           |
| <b>Deferred tax liabilities:</b>                 |                     |                     |
| Prepaid expenses                                 | (99,455)            | (132,940)           |
| FHLB dividends                                   | (220,188)           | (220,188)           |
| Accumulated depreciation                         | (722,309)           | (808,760)           |
| Deferred loan costs                              | (153,027)           | (139,547)           |
| Investment in limited partnership                | (290)               | (479)               |
| Accrued bonus                                    | (2,634)             | 1,103               |
| Unrealized gain on securities available for sale | (2,269,188)         | (1,881,213)         |
|  | (3,467,091)         | (3,182,024)         |
| <b>Net deferred income tax asset</b>             | <b>\$ 1,670,290</b> | <b>\$ 1,957,440</b> |



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Management has assessed the realizability of deferred tax assets and believes it is more likely than not that all deferred tax assets will be realized in the normal course of operations. Accordingly, these assets have not been reduced by a valuation allowance.

The Company periodically reviews its income tax positions based on tax laws and regulations and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities' examinations of the Company's tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment.

As of December 31, 2012, the Company had a liability for unrecognized tax benefits of \$230,000 associated with the California Franchise Tax Board's (FTB) potential exam of our 2010, 2011 and 2012 tax returns, approximately \$18,000 of which relates to interest. The Company believes the \$230,000 accrued liability is an adequate reserve for the potential of an exam for the 2010, 2011 and 2012 tax returns. If recognized, the unrecognized tax benefit would have impacted the 2012 annual effective tax rate by 0.8%.

As of December 31, 2011, the Company had a liability for unrecognized tax benefits of \$307,000 associated with the FTB's exam of our 2008 and 2009 tax return and potential exam of our 2010 and 2011 tax return, approximately \$15,000 of which was due to interest. If recognized, the unrecognized tax benefit would have impacted the 2011 annual effective tax rate by 3.4%. During 2012, the Company agreed to the settlement terms and made a payment of \$190,000 for the 2008/2009 exam, for which the final assessment notice from FTB is pending as December 31, 2012.

Detailed below is a reconciliation of the Company's unrecognized tax benefits, gross of any related tax benefits, for the year ended December 31, 2012 and 2011:

|   | <b>Years Ended December 31,</b> |             |
|---|---------------------------------|-------------|
|   | <b>2012</b>                     | <b>2011</b> |
| Beginning balance   | \$ 307,000                      | \$ 144,000  |
| Payments made to State taxing authorities, net of federal deduction | (135,000)                       | (144,000)   |
| Additions for prior year tax positions                              |                                 | 221,000     |
| Additions for current year tax positions                            | 58,000                          | 86,000      |
| Ending balance  | \$ 230,000                      | \$ 307,000  |

The effective tax rate for 2012 and 2011 differs from the current Federal statutory income tax rate as follows:

|   | <b>YEARS ENDED DECEMBER 31,</b> |             |
|---|---------------------------------|-------------|
|   | <b>2012</b>                     | <b>2011</b> |
| Federal statutory income tax rate                     | 34.0%                           | 34.0%       |
| State taxes, net of federal tax benefit               | 7.2%                            | 7.2%        |
| Tax exempt interest on municipal securities and loans | (3.2)%                          | (2.2)%      |
| Tax exempt earnings on bank owned life insurance      | (2.0)%                          | (2.0)%      |
| Stock based compensation                              | 0.1%                            | 0.2%        |
| Low income housing tax credit                         | (0.7)%                          | (0.8)%      |
| California enterprise zone tax credits and deductions | (2.8)%                          | (2.9)%      |

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|                    |       |       |
|--------------------|-------|-------|
| Other              | 0.1%  | 1.6%  |
| Effective tax rate | 32.7% | 35.1% |

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Oak Valley Bancorp files a consolidated return in the U.S. Federal tax jurisdiction and a combined report in the State of California tax jurisdiction. Prior to the formation of Bancorp in 2008, the Company filed in the U.S. Federal and California jurisdictions on a stand-alone basis. None of the entities are subject to examination by taxing authorities for years before 2009 for U.S. Federal or for years before 2008 for California.

**NOTE 12 STOCK OPTION PLAN**

The Company currently has two equity based incentive plans, the Oak Valley Community Bank 1998 Restated Stock Option Plan and the Oak Valley Bancorp 2008 Stock Plan. The 2008 Stock Plan provides for awards in the form of incentive stocks, non-statutory stock options, Stock appreciation rights and restrictive stocks. Under the 2008 Plan, the Company is authorized to issue 1,500,000 shares of its common stock to key employees and directors as incentive and non-qualified stock options, respectively, at a price equal to the fair value on the date of grant. The Plan provides that the options are exercisable in equal increments over a five-year period from the date of grant or over any other schedule approved by the Board of Directors. All incentive stock options expire no later than ten years from the date of grant. Future grants are not permitted under the 1998 Stock Plan and will all be issued from the 2008 Stock Plan.

A summary of the status of the Company's fixed stock option plan and changes during the year are presented below.

|                                  | DECEMBER 31, 2012 |                                 |
|----------------------------------|-------------------|---------------------------------|
|                                  | Shares            | Weighted-Average Exercise Price |
| Outstanding at beginning of year | 281,623           | \$ 8.16                         |
| Granted                          | 0                 | \$ 0.00                         |
| Exercised                        | (54,436)          | \$ 4.04                         |
| Forfeited                        | 0                 | \$ 0.00                         |
| Outstanding at end of year       | 227,187           | \$ 9.15                         |

A summary of the status of the Company's restricted stock and changes during the year are presented below.

|                               | DECEMBER 31, 2012 |  |
|-------------------------------|-------------------|--|
|                               | Shares            | Weighted-Average Grant Date Fair Value |
| Unvested at beginning of year | 13,305            | \$ 5.73                                |
| Granted                       | 139,375           | \$ 6.74                                |
| Vested                        | (2,661)           | \$ 5.73                                |
| Cancelled                     | (4,500)           | \$ 6.74                                |
| Unvested at end of year       | 145,519           | \$ 6.67                                |





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|  | DECEMBER 31, |            |
|--|--------------|------------|
|  | 2012         | 2011       |
| Weighted-average fair value of options granted during the year | \$ N/A       | \$ N/A     |
| Intrinsic value of options exercised                           | \$ 164,164   | \$ 8,075   |
| Options exercisable at year end:                               | 226,487      | 276,123    |
| Weighted average exercise price                                | \$ 9.16      | \$ 8.14    |
| Intrinsic value  | \$ 22,420    | \$ 157,228 |
| Weighted average remaining contractual life                    | 1.90 years   | 2.40 years |
| Options outstanding at year end:                               | 227,187      | 281,623    |
| Weighted average exercise price                                | \$ 9.15      | \$ 8.16    |
| Intrinsic value  | \$ 22,623    | \$ 159,787 |
| Weighted average remaining contractual life                    | 1.91 years   | 2.47 years |

There were no tax benefits recorded in the consolidated statements of income during 2012 and 2011 related to the vesting of non-qualified stock options. As of December 31, 2012, there was \$1,000 of total unrecognized compensation cost related to non-vested stock options which is expected to be recognized over a weighted-average period of 1.04 years.

For the year ended December 31, 2012, the Company received proceeds of approximately \$220,000 from the exercise of stock options and received income tax benefits of approximately \$37,000 related to disqualifying dispositions in the exercise of incentive stock options.

The Company granted 139,375 shares of restricted stock in 2012 with a weighted average fair value of \$6.74 per share. For the year ended December 31, 2012, total compensation expense recorded in the consolidated statements of income related to restricted stock awards was \$160,000, with an offsetting tax benefit of \$66,000, as this expense is deductible for income tax purposes. As of December 31, 2012, there was \$765,000 of total unrecognized compensation cost related to restricted stock awards which is expected to be recognized over a weighted-average period of 4.09 years. During 2012, shares of restricted stock awards totaling 2,661 with a fair value of \$18,000 were vested and became unrestricted.

For the year ended December 31, 2011, the Company received \$9,900 from the exercise of stock options and received no income tax benefits related to the exercise of non-qualified employee stock options and disqualifying dispositions in the exercise of incentive stock options.

The Company granted 13,305 shares of restricted stock in 2011 with a weighted average fair value of \$5.73 per share. For the year ended December 31, 2011, total compensation expense recorded in the consolidated statement of income related to restricted stock awards was \$12,000, with an offsetting tax benefit of \$5,000, as this expense is deductible for income tax purposes. As of December 31, 2011, there was \$64,000 of total unrecognized compensation cost related to restricted stock awards which is expected to be recognized over a weighted-average period of 4.23 years. No restricted stock shares vested during 2011.

### **NOTE 13 TREASURY CAPITAL PURCHASE PROGRAM**

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In response to the stresses in the credit markets and to protect and recapitalize the U.S. financial system, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 ( EESA ) was signed into law. EESA includes the Treasury Capital Purchase Program (the TCPP ), which was intended to inject liquidity into, and stabilize the financial industry. On December 1, 2008, we received preliminary approval from the United States Department of the Treasury (the U.S. Treasury ) to participate in the TCPP. On December 5, 2008, the Company issued to the U.S. Treasury 13,500 shares of senior preferred stock with a zero par value and a \$1,000 per share liquidation preference, along with warrants to purchase 350,346 shares of common stock at a per share exercise price of \$5.78, in exchange for aggregate consideration of \$13.5 million. The attached warrants were immediately exercisable and expired 10 years after the issuance date. We were required to comply with restrictions on executive compensation during the period that the U.S. Treasury held an equity position in us through the TCPP.

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The proceeds of \$13.5 million were allocated between the preferred stock and the warrants with \$12.7 million allocated to preferred stock and \$833 thousand allocated to the warrants, based on their relative fair value at the time of issuance. The fair value of the preferred stock was estimated using discounted cash flows with a discount rate of 9%. The fair value of the warrants was estimated using the Binomial option pricing model with the following assumptions: 1) risk-free interest rate of 2.66% (the Treasury 10-year yield rate as of warrant issuance date); 2) estimated life of ten years (contractual term of the warrants); 3) volatility of 37.4%; and 4) dividend yield of 1.67%. The discount on the preferred stock (i.e., difference between the initial carrying amount and the liquidation amount) was scheduled to be amortized over a five-year period, using effective yield method.

See Note 3 above for information regarding the Company's repurchase of the Series A preferred shares from the TCPP, issuance of Series B preferred stock under the SBLF and redemption of warrants in August 2011.

**NOTE 14 EARNINGS PER SHARE**

Earnings per share (EPS) are based upon the weighted average number of common shares outstanding during each year. The following table shows: (1) weighted average basic shares, (2) effect of dilutive securities related to stock options and non-vested restricted stock, and (3) weighted average diluted shares. Net income available to common stockholders is calculated as net income reduced by dividends accumulated on preferred stock. Basic EPS are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average diluted shares. The total dilutive shares included in annual diluted EPS is a year-to-date weighted average of the total dilutive shares included in each quarterly diluted EPS computation under the treasury stock method. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of restricted stock awards receive non-forfeitable dividends at the same rate as common stockholders and they both share equally in undistributed earnings.

The Company's calculation of earnings per share (EPS) including basic EPS, which does not consider the effect of common stock equivalents and diluted EPS, which considers all dilutive common stock equivalents is as follows:

|  | YEAR ENDED DECEMBER 31, 2012 |                         |                     |
|--|------------------------------|-------------------------|---------------------|
|  | Income<br>(Numerator)        | Shares<br>(Denominator) | Per-Share<br>Amount |
| <b>Basic EPS:</b>  |                              |                         |                     |
| Net earnings available to common shareholders                          | \$ 5,328,980                 | 7,740,990               | \$ 0.69             |
| <b>Effect of dilutive securities:</b>                                  |                              |                         |                     |
| Stock options  |                              | 9,647                   |                     |
| Non-vested restricted stock  |                              | 16,108                  |                     |
| Total dilutive shares  |                              | 25,755                  |                     |
| <b>Diluted EPS:</b>  |                              |                         |                     |
| Net earnings available to common shareholders plus assumed conversions | \$ 5,328,980                 | 7,766,745               | \$ 0.69             |

Anti-dilutive options to purchase 208,375 shares of common stock in prices ranging from \$7.20 to \$15.67 were outstanding during 2012. They were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common

shares. These options begin to expire in 2015.

During 2012, anti-dilutive non-vested restricted stock grants of 740 weighted average shares of common stock were outstanding with a grant date fair value price of \$7.20. These shares were anti-dilutive because the fair value of the grant was higher than the average market price of the common shares.

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|  | YEAR ENDED DECEMBER 31, 2011 |                         |                     |
|--|------------------------------|-------------------------|---------------------|
|  | Income<br>(Numerator)        | Shares<br>(Denominator) | Per-Share<br>Amount |
| <b>Basic EPS:</b>  |                              |                         |                     |
| Net earnings available to common shareholders                          | \$ 4,699,539                 | 7,708,853               | \$ 0.61             |
| <b>Effect of dilutive securities:</b>                                  |                              |                         |                     |
| Stock options  |                              | 13,888                  |                     |
| Restricted stock   |                              | 10,273                  |                     |
| Warrants   |                              | 5,985                   |                     |
| Total dilutive shares  |                              | 30,146                  |                     |
| <b>Diluted EPS:</b>  |                              |                         |                     |
| Net earnings available to common shareholders plus assumed conversions | \$ 4,699,539                 | 7,738,999               | \$ 0.61             |

Anti-dilutive options to purchase 219,625 shares of common stock in prices ranging from \$7.00 to \$15.67 were outstanding during 2011. They were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares. These options begin to expire in 2015. In addition, warrants issued to the U.S. Treasury related to the Capital Purchase Program of 350,346 with a price of \$5.78 were dilutive and included in EPS because the warrants' exercise price was less than the average market price of the common shares. The Company redeemed all of these warrants in September 2011 with a payment to the U.S. Treasury of \$560,000.

**NOTE 15 COMMITMENTS AND CONTINGENCIES**

The Company is obligated for rental payments under certain operating lease agreements, some of which contain renewal options and escalation clauses that provide for increased rentals. Total rental expense for the years ended December 31, 2012 and 2011, was \$890,000 and \$884,000, respectively.

At December 31, 2012, the future minimum commitments under these operating leases are as follows:

| Year ending December 31, |              |
|--------------------------|--------------|
| 2013                     | \$ 869,241   |
| 2014                     | 848,214      |
| 2015                     | 653,087      |
| 2016                     | 494,301      |
| 2017                     | 363,436      |
| Thereafter               | 1,623,146    |
|                          | \$ 4,851,425 |

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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Financial instruments at December 31, 2012 whose contract amounts represent credit risk:

|                              | <b>Contract<br/>Amount</b> |
|------------------------------|----------------------------|
| Undisbursed loan commitments | \$ 29,584,667              |
| Checking reserve             | 1,206,517                  |
| Equity lines                 | 10,872,517                 |
| Standby letters of credit    | 539,942                    |
|                              | <b>\$ 42,203,643</b>       |

Commitments to extend credit, including undisbursed loan commitments and equity lines, are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property, plant, equipment and income-producing commercial properties.

Checking reserves are lines of credit associated consumer deposit accounts that meet qualification standards for extension of credit if the deposit account were to become overdraft.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

**NOTE 16 FINANCIAL INSTRUMENTS**

**Fair values of financial instruments** The consolidated financial statements include various estimated fair value information as of December 31, 2012 and 2011. Such information, which pertains to the Company's financial instruments, does not purport to represent the aggregate net fair value of the Company. Further, the fair value estimates are based on various assumptions, methodologies, and subjective considerations, which vary widely among different financial institutions and which are subject to change. The following methods and assumptions are used by the Company.

*Cash and cash equivalents* The carrying amounts of cash and cash equivalents approximate their fair value.

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



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*Securities (including mortgage-backed securities)* Fair values for securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. See Note 17 for additional disclosure regarding fair values of securities.

*Loans receivable* For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair values for other loans (e.g., real estate construction and mortgage, commercial, and installment loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The allowance for loan losses is considered to be a reasonable estimate of loan discount due to credit risks.

*Deposit liabilities* The fair values estimated for demand deposits (interest and non-interest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). The carrying amounts for variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of the aggregate expected monthly maturities on time deposits.

*Federal Home Loan Bank (FHLB) advances* Rates currently available to the Company for borrowings with similar terms and remaining maturities are used to estimate the fair value of the existing debt.

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*Interest receivable and payable* The carrying amounts of accrued interest approximate their fair value.

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

The estimated fair values of the Company's financial instruments at December 31, 2012 were as follows:

|  | Carrying<br>Amount | Fair<br>Value  | Hierarchy<br>Valuation<br>Level |
|--|--------------------|----------------|---------------------------------|
| <b>Financial assets:</b>                       |                    |                |                                 |
| Cash and cash equivalents                      | \$ 141,334,998     | \$ 141,334,998 | 1                               |
| Restricted equity securities                   | 3,129,750          | 3,129,750      | 2                               |
| Loans, net                                     | 382,411,361        | 398,029,908    | 3                               |
| Interest receivable                            | 1,654,474          | 1,654,474      | 2                               |
| <b>Financial liabilities:</b>                  |                    |                |                                 |
| Deposits                                       | (586,992,650)      | (587,430,712)  | 3                               |
| Interest payable                               | (67,958)           | (67,958)       | 2                               |
| <b>Off-balance-sheet assets (liabilities):</b> |                    |                |                                 |
| Commitments and standby letters of credit      |                    | (422,036)      | 3                               |

The estimated fair values of the Company's financial instruments at December 31, 2011 were as follows:

|  | Carrying<br>Amount | Fair<br>Value  | Hierarchy<br>Valuation<br>Level |
|--|--------------------|----------------|---------------------------------|
| <b>Financial assets:</b>                       |                    |                |                                 |
| Cash and cash equivalents                      | \$ 101,084,775     | \$ 101,084,775 | 1                               |
| Restricted equity securities                   | 3,993,800          | 3,993,800      | 2                               |
| Loans, net                                     | 386,958,076        | 401,051,975    | 3                               |
| Interest receivable                            | 1,703,457          | 1,703,457      | 2                               |
| <b>Financial liabilities:</b>                  |                    |                |                                 |
| Deposits                                       | (536,204,003)      | (536,791,880)  | 3                               |
| FHLB advance                                   | (3,000,000)        | (3,002,834)    | 2                               |
| Interest payable                               | (129,272)          | (129,272)      | 2                               |
| <b>Off-balance-sheet assets (liabilities):</b> |                    |                |                                 |
| Commitments and standby letters of credit      |                    | (464,029)      | 3                               |

Table of Contents**NOTE 17 – FAIR VALUE MEASUREMENTS**

ASC Topic 820, Fair Value Measurements, which the Company adopted effective January 1, 2008, defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follow:

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

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

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

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally corresponds with the Company's quarterly valuation process.

Assets and liabilities measured at fair value on a recurring and non-recurring basis for the years ended December 31, 2012 and 2011 are summarized below:

|   | Fair Value Measurements at December 31, 2012 Using |  |   |  |
|---|--|--|---|--|
|   | December 31,<br>2012                               | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets and liabilities measured on a recurring basis:     |  |  |   |  |
| Available-for-sale securities                             |  |  |   |  |
| U.S. agencies   | \$ 55,517,059                                      | \$ 0   | \$ 55,517,059   | \$ 0   |
| Collateralized mortgage obligations                       | 12,604,384   | 0  | 12,604,384  | 0  |
| Municipalities  | 26,992,288   | 0  | 26,992,288  | 0  |
| SBA Pools   | 1,178,308  | 0  | 1,178,308   | 0  |
| Corporate debt  | 4,705,602  | 0  | 4,705,602   | 0  |
| Mutual Fund   | 2,868,240  | 2,868,240  | 0   | 0  |
| Assets and liabilities measured on a non-recurring basis: |  |  |   |  |
| Impaired Loans  | \$ 4,980,341                                       | \$ 0   | \$ 0  | \$ 4,980,341                                       |
| Other real estate owned                                   | \$ 0   | \$ 0   | \$ 0  | \$ 0   |



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|   | Fair Value Measurements at December 31, 2011 Using |  |   |  |
|---|--|--|---|--|
|   | December 31,<br>2011                               | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets and liabilities measured on a recurring basis:     |  |  |   |  |
| Available-for-sale securities                             |  |  |   |  |
| U.S. agencies   | \$ 54,809,308                                      | \$ 0   | \$ 54,809,308   | \$ 0   |
| Collateralized mortgage obligations                       | 12,094,472   | 0  | 12,094,472  | 0  |
| Municipalities  | 16,972,042   | 0  | 16,972,042  | 0  |
| SBA Pools   | 1,236,421  | 0  | 1,236,421   | 0  |
| Corporate debt  | 1,814,284  | 0  | 1,814,284   | 0  |
| Mutual Fund   | 2,768,332  | 2,768,332  | 0   | 0  |
| Assets and liabilities measured on a non-recurring basis: |  |  |   |  |
| Impaired Loans  | \$ 4,650,738                                       | \$ 0   | \$ 0  | \$ 4,650,738                                       |
| Other real estate owned                                   | \$ 244,375   | \$ 0   | \$ 0  | \$ 244,375   |

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

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

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

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

**NOTE 18 RELATED PARTY TRANSACTIONS**

The Company, in the normal course of business, makes loans and receives deposits from its directors, officers, principal shareholders, and their associates. In management's opinion, these transactions are on substantially the same terms as comparable transactions with other customers of the Company. Loans to directors, officers, shareholders, and affiliates are summarized below:

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|   | YEARS ENDED DECEMBER 31, |              |
|---|--------------------------|--------------|
|   | 2012                     | 2011         |
| Aggregate amount outstanding, beginning of year | \$ 6,178,238             | \$ 8,019,148 |
| New loans or advances during year               | 5,354,389                | 1,441,886    |
| Repayments during year                          | (3,156,886)              | (3,282,796)  |
| Aggregate amount outstanding, end of year       | \$ 8,375,741             | \$ 6,178,238 |

Related party deposits totaled \$59,025,000 and \$13,893,000 at December 31, 2012 and 2011, respectively.

**NOTE 19 PROFIT SHARING PLAN**

The profit sharing plan to which both the Company and eligible employees contribute was established in 1995. Bank contributions are voluntary and at the discretion of the Board of Directors. Contributions were approximately \$335,000 and \$283,000 for the years ended December 31, 2012 and 2011, respectively.

**NOTE 20 RESTRICTIONS ON DIVIDENDS**

Under current California State banking laws, the Bank may not pay cash dividends in an amount that exceeds the lesser of retained earnings of the Bank or the Bank's net earnings for its last three fiscal years (less the amount of any distributions to shareholders made during that period). If the above requirements are not met, cash dividends may only be paid with the prior approval of the Commissioner of the Department of Financial Institutions, in an amount not exceeding the Bank's net earnings for its last fiscal year or the amount of its net earnings for its current fiscal year. Accordingly, the future payment of cash dividends will depend on the Bank's earnings and its ability to meet its capital requirements.

**NOTE 21 OTHER POST-RETIREMENT BENEFIT PLANS**

The Company has awarded certain officers a salary continuation plan (the "Plan"). Under the Plan, the participants will be provided with a fixed annual retirement benefit for 20 years after retirement. The Company is also responsible for certain pre-retirement death benefits under the Plan. In connection with the implementation of the Plan, the Company purchased single premium life insurance policies on the life of each of the officers covered under the Plan. The Company is the owner and partial beneficiary of these life insurance policies. The assets of the Plan, under Internal Revenue Service regulations, are owned by the Company and are available to satisfy the Company's general creditors.

During December 2001, the Company awarded its directors a director retirement plan ("DRP"). Under the DRP, the participants will be provided with a fixed annual retirement benefit for ten years after retirement. The Company is also responsible for certain pre-retirement death benefits under the DRP. In connection with the implementation of the DRP, the Company purchased single premium life insurance policies on the life of each director covered under the DRP. The Company is the owner and partial beneficiary of these life insurance policies. The assets of the DRP, under Internal Revenue Service regulations, are the property of the Company and are available to satisfy the Company's general creditors.

Future compensation under both plans is earned for services rendered through retirement. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the plans. The Company's current benefit liability is determined based on vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which average approximately 20 years. At December 31, 2012 and 2011, \$1,800,000 and \$1,511,000, respectively, has been accrued to date, and is included in other liabilities on the consolidated balance sheets.

The Company entered into split-dollar life insurance agreements with certain officers. In connection with the implementation of the split-dollar agreements, the Company purchased single premium life insurance policies on the life of each of the officers covered by the split-dollar life insurance agreements. The Company is the owner of the policies and the partial beneficiary in an amount equal to the cash surrender value of the policies.

The combined cash surrender value of all Bank-owned life insurance policies was \$11,679,634 and \$11,255,877 at December 31, 2012 and 2011, respectively. The cash surrender value of the life insurance policies is included in other assets on the consolidated balance sheets (Note 7).



Table of Contents**NOTE 22 REGULATORY MATTERS**

The Bank and the Company are subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table on the next page) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2012, that the Bank and Company meets all capital adequacy requirements to which they are subject.

As of December 31, 2011, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. There are no conditions or events since notification that management believes have changed the Bank's category.

The Company and Bank's actual capital amounts and ratios at December 31, 2012 and 2011, are presented in the following table.

|   | Actual        |       | For capital adequacy purposes |       | To be well capitalized under prompt corrective action provisions |        |
|---|---------------|-------|-------------------------------|-------|--|--------|
|   | Amount        | Ratio | Amount                        | Ratio | Amount   | Ratio  |
| <b>Capital ratios for Bank:</b>           |               |       |                               |       |  |        |
| As of December 31, 2012                   |               |       |                               |       |  |        |
| Total capital (to Risk- Weighted Assets)  | \$ 72,230,000 | 16.0% | \$ 36,028,000                 | ≥8.0% | \$ 45,035,000  | ≥10.0% |
| Tier I capital (to Risk- Weighted Assets) | \$ 66,570,000 | 14.8% | \$ 18,014,000                 | ≥4.0% | \$ 27,021,000  | ≥6.0%  |
| Tier I capital (to Average Assets)        | \$ 66,570,000 | 10.3% | \$ 25,848,000                 | ≥4.0% | \$ 32,310,000  | ≥5.0%  |
| As of December 31, 2011                   |               |       |                               |       |  |        |
| Total capital (to Risk- Weighted Assets)  | \$ 73,562,000 | 16.2% | \$ 36,384,000                 | ≥8.0% | \$ 45,481,000  | ≥10.0% |
| Tier I capital (to Risk- Weighted Assets) | \$ 67,835,000 | 14.9% | \$ 18,192,000                 | ≥4.0% | \$ 27,288,000  | ≥6.0%  |
| Tier I capital (to Average Assets)        | \$ 67,835,000 | 11.4% | \$ 23,807,000                 | ≥4.0% | \$ 29,759,000  | ≥5.0%  |

**Capital ratios for Bancorp:**

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As of December 31, 2012

|   |    |            |       |    |            |       |     |     |
|---|----|------------|-------|----|------------|-------|-----|-----|
| Total capital (to Risk- Weighted Assets)  | \$ | 72,376,000 | 16.1% | \$ | 36,030,000 | ≥8.0% | N/A | N/A |
| Tier I capital (to Risk- Weighted Assets) | \$ | 66,716,000 | 14.8% | \$ | 18,015,000 | ≥4.0% | N/A | N/A |
| Tier I capital (to Average Assets)        | \$ | 66,716,000 | 10.3% | \$ | 25,850,000 | ≥4.0% | N/A | N/A |

As of December 31, 2011

|   |    |            |       |    |            |       |     |     |
|---|----|------------|-------|----|------------|-------|-----|-----|
| Total capital (to Risk- Weighted Assets)  | \$ | 73,439,000 | 16.2% | \$ | 36,387,000 | ≥8.0% | N/A | N/A |
| Tier I capital (to Risk- Weighted Assets) | \$ | 67,712,000 | 14.9% | \$ | 18,193,000 | ≥4.0% | N/A | N/A |
| Tier I capital (to Average Assets)        | \$ | 67,712,000 | 11.4% | \$ | 23,809,000 | ≥4.0% | N/A | N/A |

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Table of Contents**OAK VALLEY BANCORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****23. PARENT ONLY CONDENSED FINANCIAL STATEMENTS****CONDENSED BALANCE SHEETS**

|   | December 31,<br>2012 | December 31,<br>2011 |
|---|----------------------|----------------------|
| <b>ASSETS</b>   |                      |                      |
| Cash  | \$ 202,934           | \$ 20,526            |
| Investment in bank subsidiary   | 69,821,699           | 70,524,665           |
| Other assets  | 28,466               | 25,565               |
| <b>Total Assets</b>   | <b>\$ 70,053,099</b> | <b>\$ 70,570,756</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                      |                      |
| Other liabilities   | \$ 84,375            | \$ 168,750           |
| <b>Total liabilities</b>  | <b>\$ 84,375</b>     | <b>\$ 168,750</b>    |
| <b>Shareholders' equity</b>   |                      |                      |
| Series B Preferred stock, no par value; \$1,000 per share liquidation preference, 10,000,000 shares authorized, 6,750 and 13,500 issued and outstanding at December 31, 2012 and 2011, respectively | 6,750,000            | 13,500,000           |
| Common stock, no par value; 50,000,000 shares authorized, 7,907,780 and 7,718,469 shares issued and outstanding at December 31, 2012 and 2011, respectively   | 23,673,210           | 23,453,443           |
| Additional paid-in capital  | 2,341,814            | 2,128,700            |
| Retained earnings   | 33,958,737           | 28,629,757           |
| Accumulated other comprehensive income, net of tax  | 3,244,963            | 2,690,106            |
| <b>Total shareholders' equity</b>   | <b>69,968,724</b>    | <b>70,402,006</b>    |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 70,053,099</b> | <b>\$ 70,570,756</b> |

Table of Contents**OAK VALLEY BANCORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****23. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (CONTINUED)****CONDENSED STATEMENTS OF INCOME**

|  | <b>Year Ended December 31,</b> |              |
|--|--------------------------------|--------------|
|  | <b>2012</b>                    | <b>2011</b>  |
| <b>INCOME</b>  |                                |              |
| Dividends declared by subsidiary                           | \$ 7,286,250                   | \$ 1,152,500 |
| Total income   | 7,286,250                      | 1,152,500    |
| <b>EXPENSES</b>  |                                |              |
| Salary expense   | 71,000                         | 70,000       |
| Employee benefit expense                                   | 175,896                        | 0            |
| Legal expense  | 43,632                         | 86,224       |
| Other operating expenses                                   | 119,255                        | 66,587       |
| Total non-interest expense                                 | 409,783                        | 222,811      |
| Income before equity in undistributed income of subsidiary | 6,876,467                      | 929,689      |
| Equity in undistributed net (loss) income of subsidiary    | (1,257,823)                    | 4,839,209    |
| Income before income tax benefit                           | 5,618,644                      | 5,768,898    |
| Income tax benefit   | 162,211                        | 91,697       |
| Net Income   | \$ 5,780,855                   | \$ 5,860,595 |
| Preferred Stock dividends and accretion                    | 451,875                        | 1,161,056    |
| Net income available to common shareholders                | \$ 5,328,980                   | \$ 4,699,539 |

Table of Contents**OAK VALLEY BANCORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****23. PARENT ONLY CONDENSED FINANCIAL STATEMENTS (CONTINUED)****CONDENSED STATEMENTS OF CASHFLOWS**

|  | <b>YEAR ENDED DECEMBER 31,</b> |                  |
|--|--------------------------------|------------------|
|  | <b>2012</b>                    | <b>2011</b>      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                 |                                |                  |
| Net income   | \$ 5,780,855                   | \$ 5,860,595     |
| Adjustments to reconcile net earnings to net cash from operating activities: |                                |                  |
| Undistributed net loss (income) of subsidiary                                | 1,257,823                      | (4,839,209)      |
| Stock based compensation   | 175,896                        | 0                |
| Excess tax benefits from stock-based payment arrangements                    | (37,218)                       | 0                |
| (Decrease) increase in other liabilities                                     | (84,375)                       | 168,750          |
| Decrease (increase) in other assets  | 34,317                         | (3,086)          |
| Net cash from operating activities   | 7,127,298                      | 1,187,050        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                 |                                |                  |
| Repurchase of Series A Preferred Stock                                       | 0                              | (13,500,000)     |
| Repurchase of Series B Preferred Stock                                       | (6,750,000)                    | 0                |
| Proceeds from Series B Preferred Stock issued                                | 0                              | 13,500,000       |
| Preferred stock dividend payment   | (451,875)                      | (761,249)        |
| Payment to repurchase U.S. Treasury Warrant                                  | 0                              | (560,000)        |
| Proceeds from sale of common stock and exercise of stock options             | 219,767                        | 9,894            |
| Excess tax benefits from stock-based payment arrangements                    | 37,218                         | 0                |
| Net cash used in financing activities  | (6,944,890)                    | (1,311,355)      |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                  | <b>182,408</b>                 | <b>(124,305)</b> |
| <b>CASH AND CASH EQUIVALENTS, beginning of period</b>                        | <b>20,526</b>                  | <b>144,831</b>   |
| <b>CASH AND CASH EQUIVALENTS, end of period</b>                              | <b>\$ 202,934</b>              | <b>\$ 20,526</b> |

**24. SUBSEQUENT EVENTS**

On March 13, 2013, Oak Valley Bancorp repurchased from the U.S. Treasury 6,750 shares of Non-Cumulative Perpetual Preferred Stock, Series B. The aggregate consideration paid to the U.S. Treasury was \$6,817,500, reflecting \$6,750,000 paid for the repurchase, and \$67,500 paid for accrued dividends. Oak Valley Bancorp had originally issued 13,500 shares of Non-Cumulative Perpetual Preferred Stock, Series B to the U.S. Treasury in September 2011 in connection with Oak Valley Bancorp's participation in the U.S. Treasury Small Business Lending Fund (SBLF) Program. In May 2012, however, Oak Valley Bancorp had repurchased 6,750 shares of Non-Cumulative Perpetual Preferred Stock, Series B from the U.S. Treasury. So, no shares of Non-Cumulative Perpetual Preferred Stock, Series B are now outstanding as a result of the current

repurchase.

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**INDEX TO EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 2.1                       | Agreement and Plan of Merger between the Registrant, Interim Oak Valley Bancorp, Inc. and Oak Valley Community Bank*   |
| 3.1                       | Articles of Incorporation of Oak Valley Bancorp, Inc.*   |
| 3.2                       | First Amendment to Articles of Incorporation of Oak Valley Bancorp, Inc.*  |
| 3.3                       | Bylaws of Oak Valley Bancorp, Inc.*  |
| 3.4                       | First Amended and Restated Bylaws of Oak Valley Bancorp, Inc.**  |
| 3.5                       | Certificate of Determination of Series A Preferred Stock of Oak Valley Bancorp, Inc.**   |
| 3.6                       | Letter Agreement between the United States Department of the Treasury and Oak Valley Bancorp dated December 5, 2008**  |
| 3.7                       | Certificate of Amendment of Bylaws dated effective as of August 11, 2011*****  |
| 4.1                       | Certificate of Determination dated December 2, 2008 filed with the California Secretary of State for Fixed Rate Cumulative Perpetual Preferred Stock, Series A**   |
| 4.2                       | Warrant to Purchase Common Stock dated December 5, 2008**  |
| 4.3                       | Certificate of Determination dated August 11, 2011 and filed with the California Secretary of State for Senior Non-Cumulative Perpetual Preferred Stock, Series B*****   |
| 10.1                      | Oak Valley Community Bank 1998 Restated Stock Option Plan*   |
| 10.2                      | Oak Valley Community Bank Form of Director Retirement Agreement*   |
| 10.3                      | Oak Valley Community Bank Form of Salary Continuation Agreement*   |
| 10.4                      | Securities Purchase Agreement between Oak Valley Bancorp and the U.S. Treasury effective December 4, 2008**  |
| 10.5                      | Securities Purchase Agreement dated August 11, 2011 between the Company and the Secretary of the U.S. Treasury, with respect to the issuance and sale of Senior Non-Cumulative Perpetual Preferred Stock, Series B.***** |
| 10.6                      | Warrant Redemption Letter Agreement dated September 28, 2011 between the Company and the U.S. Treasury, with respect to the redemption of the Warrant to Purchase Common Stock dated December 5, 2008.*****              |
| 14                        | Code of Ethics***  |
| 21                        | Subsidiaries of the Issuer*  |
| 23.1                      | Consent of Independent Registered Accounting Firm  |
| 24                        | Power of Attorney (included on the signature page of this report)  |
| 31.01                     | Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |

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31.02 Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

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32.01 Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.01 XBLR Interactive Data File\*\*\*\*\*

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\* Incorporated by reference from the Form 10 filed on July 31, 2008

\*\* Incorporated by reference from the Form 8-A filed on January 14, 2009

\*\*\* Incorporated by reference from the Form 10-K filed on March 31, 2009

\*\*\*\* Incorporated by reference from the Form 10-Q filed on November 14, 2011

\*\*\*\*\* As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

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