UNITED SECURITY BANCSHARES
Form 10-Q
November 02, 2018
Table of Contents

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2018
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .

Commission file number: 000-32897

UNITED SECURITY BANCSHARES
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| CALIFORNIA | 91-2112732 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 2126 Inyo Street, Fresno, California | 93721 |
| (Address of principal executive offices) | (Zip Code) |

Registrants telephone number, including area code (559) 248-4943

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

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 for the past 90 days. Yes x No o

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 x No o

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

| | | |
|---|---|---|
| Large accelerated filer o | Accelerated filer x | Non-accelerated filer o |
| Small reporting company o | | Emerging growth company o |

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

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

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

Common Stock, no par value
(Title of Class)

Shares outstanding as of October 31, 2018: 16,903,290

1

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I. Financial Information

United Security Bancshares and Subsidiaries
Consolidated Balance Sheets – (unaudited)
September 30, 2018 and December 31, 2017

| (in thousands except shares) | September 30, 2018 | December 31, 2017 |
|---|---|---|
| Assets | | |
| Cash and non-interest bearing deposits in other banks | $ 28,952 | $ 35,237 |
| Due from Federal Reserve Bank ("FRB") | 178,348 | 72,697 |
| Cash and cash equivalents | 207,300 | 107,934 |
| Investment securities (at fair value) | | |
| Available for sale ("AFS") securities | 62,103 | 41,985 |
| Marketable equity securities | 3,624 | 3,737 |
| Total investment securities | 65,727 | 45,722 |
| Loans | 577,115 | 601,351 |
| Unearned fees and unamortized loan origination costs, net | 483 | 1,039 |
| Allowance for credit losses | (8,798) | (9,267) |
| Net loans | 568,800 | 593,123 |
| Premises and equipment – net | 9,875 | 10,165 |
| Accrued interest receivable | 9,412 | 6,526 |
| Other real estate owned | 5,745 | 5,745 |
| Goodwill | 4,488 | 4,488 |
| Deferred tax assets - net | 2,760 | 2,389 |
| Cash surrender value of life insurance | 19,935 | 19,752 |
| Investment in limited partnerships | 1,588 | 1,601 |
| Other assets | 8,398 | 8,391 |
| Total assets | $ 904,028 | $ 805,836 |
| | | |
| Liabilities & Shareholders' Equity | | |
| Liabilities | | |
| Deposits | | |
| Noninterest bearing | $ 315,213 | $ 307,299 |
| Interest bearing | 463,670 | 380,394 |
| Total deposits | 778,883 | 687,693 |
| | | |
| Accrued interest payable | 57 | 44 |
| Other liabilities | 7,639 | 7,017 |
| Junior subordinated debentures (at fair value) | 10,403 | 9,730 |
| Total liabilities | 796,982 | 704,484 |
| | | |
| Shareholders' Equity | | |
| Common stock, no par value; 20,000,000 shares authorized; issued and outstanding: 16,903,290 at September 30, 2018 and 16,885,615 at December 31, 2017 | 58,472 | 57,880 |
| Retained earnings | 47,852 | 44,182 |
| Accumulated other comprehensive income (loss) | 722 | (710) |
| Total shareholders' equity | 107,046 | 101,352 |
| Total liabilities and shareholders' equity | $ 904,028 | $ 805,836 |

3

United Security Bancshares and Subsidiaries
Consolidated Statements of Income
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (In thousands except shares and EPS) | 2018 | 2017 | 2018 | 2017 |
| Interest Income: | | | | |
| Interest and fees on loans | $8,397 | $ 7,978 | $24,114 | $ 22,782 |
| Interest on investment securities | 351 | 238 | 809 | 691 |
| Interest on deposits in FRB | 806 | 375 | 1,870 | 858 |
| Interest on deposits in other banks | — | 1 | — | 4 |
| Total interest income | 9,554 | 8,592 | 26,793 | 24,335 |
| Interest Expense: | | | | |
| Interest on deposits | 579 | 355 | 1,517 | 1,055 |
| Interest on other borrowed funds | 112 | 80 | 311 | 223 |
| Total interest expense | 691 | 435 | 1,828 | 1,278 |
| Net Interest Income | 8,863 | 8,157 | 24,965 | 23,057 |
| (Recovery of Provision) Provision for Credit Losses | (373) | 7 | (1,699) | (24) |
| Net Interest Income after (Recovery of Provision) Provision for Credit Losses | 9,236 | 8,150 | 26,664 | 23,081 |
| Noninterest Income: | | | | |
| Customer service fees | 815 | 959 | 2,787 | 2,897 |
| Increase in cash surrender value of bank-owned life insurance | 132 | 134 | 389 | 400 |
| Loss on marketable equity securities | (35) | — | (114) | — |
| Gain on proceeds from bank-owned life insurance | — | — | 171 | — |
| Loss on fair value of junior subordinated debentures | (262) | (88) | (923) | (688) |
| Gain on sale of investment in limited partnership | — | 3 | — | 3 |
| Gain on sale of assets | — | — | 29 | — |
| Other | 199 | 168 | 601 | 539 |
| Total noninterest income | 849 | 1,176 | 2,940 | 3,151 |
| Noninterest Expense: | | | | |
| Salaries and employee benefits | 2,826 | 2,578 | 8,798 | 8,149 |
| Occupancy expense | 1,121 | 1,087 | 3,256 | 3,144 |
| Data processing | 13 | 29 | 104 | 81 |
| Professional fees | 408 | 312 | 1,134 | 912 |
| Regulatory assessments | 87 | 43 | 248 | 313 |
| Director fees | 78 | 72 | 239 | 215 |
| Correspondent bank service charges | 15 | 18 | 48 | 55 |
| Loss (gain) on California tax credit partnership | 5 | (1) | 14 | 118 |
| Net cost (gain) on operation and sale of OREO | 30 | 21 | 129 | (257) |
| Other | 560 | 587 | 1,489 | 1,813 |
| Total noninterest expense | 5,143 | 4,746 | 15,459 | 14,543 |

| | | | | |
|---|---|---|---|---|
| Income Before Provision for Taxes | 4,942 | 4,580 | 14,145 | 11,689 |
| Provision for Taxes on Income | 1,424 | 1,840 | 4,077 | 4,685 |
| Net Income | $3,518 | $ 2,740 | $10,068 | $ 7,004 |
| | | | | |
| Net Income per common share | | | | |
| Basic | $0.21 | $ 0.16 | $0.60 | $ 0.41 |
| Diluted | $0.21 | $ 0.16 | $0.59 | $ 0.41 |
| Shares on which net income per common shares were based | | | | |
| Basic | 16,902,218 | 16,885,615 | 16,897,524 | 16,885,578 |
| Diluted | 16,954,053 | 16,907,267 | 16,933,477 | 16,904,063 |

4

Table of Contents

United Security Bancshares and Subsidiaries
Consolidated Statements of Comprehensive Income
(Unaudited)

| (In thousands) | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|---|---|---|---|---|
| Net Income | $ 3,518 | $ 2,740 | $ 10,068 | $ 7,004 |
| | | | | |
| Unrealized holdings (loss) gain on securities | (226) | — | (655) | 355 |
| Unrealized gains on unrecognized post-retirement costs | 14 | 13 | 41 | 39 |
| Unrealized (loss) gain on junior subordinated debentures | (14) | — | 280 | — |
| Other comprehensive (loss) income, before tax | (226) | 13 | (334) | 394 |
| Tax benefit (expense) related to securities | 67 | — | 195 | (142) |
| Tax expense related to unrecognized post-retirement costs | (4) | (5) | (12) | (16) |
| Tax benefit (expense) related to junior subordinated debentures | 4 | — | (83) | — |
| Total other comprehensive (loss) income | (159) | 8 | (234) | 236 |
| Comprehensive Income | $ 3,359 | $ 2,748 | $ 9,834 | $ 7,240 |

Table of Contents

United Security Bancshares and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
(unaudited)

| (In thousands except shares) | Common stock Number of Shares | Amount | Retained Earnings | Accumulated Other Comprehensive (Loss) Gain | Total |
|---|---|---|---|---|---|
| Balance December 31, 2016 (1) | 16,705,594 | $56,557 | $40,701 | $ (604) | $96,654 |
| (1) Excludes 12,015 unvested restricted shares | | | | | |
| Other comprehensive income | | | | 236 | 236 |
| Common stock dividends | 167,082 | 1,220 | (1,220) | | — |
| Dividends on common stock ($0.17 per share) | | | (1,688) | | (1,688) |
| Dividends payable ($0.07 per share) | | | (1,182) | | (1,182) |
| Stock options exercised | 2,514 | 6 | | | 6 |
| Restricted stock units released | 10,425 | | | | — |
| Stock-based compensation expense | | 78 | | | 78 |
| Net income | | | 7,004 | | 7,004 |
| Balance September 30, 2017 (2) | 16,885,615 | $57,861 | $43,615 | $ (368) | $101,108 |
| (2) Excludes 9,011 unvested restricted shares | | | | | |
| Other comprehensive loss | | | | (229) | (229) |
| Reclassification of income tax effects from accumulated other comprehensive income | | | 113 | (113) | — |
| Dividends payable ($0.07 per share) | | | (1,182) | | (1,182) |
| Stock-based compensation expense | | 19 | | | 19 |
| Net income | | | 1,636 | | 1,636 |
| Balance December 31, 2017 (3) | 16,885,615 | $57,880 | $44,182 | $ (710) | $101,352 |
| (3) Excludes 46,511 unvested restricted shares | | | | | |
| Other comprehensive loss | | | | (234) | (234) |
| Adoption of ASU 2016-01: reclassification of TRUPS to accumulated other comprehensive income | | | (1,482) | 1,482 | — |
| Adoption of ASU 2016-01: recognition of previously unrealized losses within marketable equity securities | | | (184) | 184 | — |
| Dividends on common stock ($0.18 per share) | | | (3,042) | | (3,042) |
| Dividends payable ($0.10 per share) | | | (1,690) | | (1,690) |
| Restricted stock units released | 17,675 | | | | — |
| Stock-based compensation expense | | 592 | | | 592 |
| Net income | | | 10,068 | | 10,068 |
| Balance September 30, 2018 (4) | 16,903,290 | $58,472 | $47,852 | $ 722 | $107,046 |
| (4) Excludes 78,508 unvested restricted shares | | | | | |

Table of Contents

United Security Bancshares and Subsidiaries
Consolidated Statements of Cash Flows (unaudited)

7

Table of Contents

| | Nine months ended September 30, | |
|---|---|---|
| (In thousands) | 2018 | 2017 |
| Cash Flows From Operating Activities: | | |
| Net Income | $10,068 | $7,004 |
| Adjustments to reconcile net income: to cash provided by operating activities: | | |
| Recovery of provision for credit losses | (1,699) | (24) |
| Depreciation and amortization | 1,005 | 996 |
| Amortization of investment securities | 409 | 406 |
| Accretion of investment securities | (3) | (6) |
| Increase in accrued interest receivable | (2,886) | (1,951) |
| Increase (decrease) in accrued interest payable | 13 | (35) |
| (Decrease) increase in accounts payable and accrued liabilities | (1,052) | 282 |
| Decrease (increase) in unearned fees and unamortized loan origination costs, net | 556 | (142) |
| Increase in income taxes receivable | (493) | (734) |
| Unrealized loss on marketable equity securities | 114 | — |
| Stock-based compensation expense | 592 | 78 |
| Provision for deferred income taxes | (190) | (283) |
| Gain on sale of other real estate owned | — | (336) |
| Gain on bank owned life insurance | (171) | — |
| Increase in cash surrender value of bank-owned life insurance | (389) | (400) |
| Loss on fair value option of junior subordinated debentures | 923 | 688 |
| Loss on tax credit limited partnership interest | 14 | 118 |
| Gain on sale of premises and equipment | (29) | — |
| Net decrease (increase) in other assets | 330 | (1,001) |
| Net cash provided by operating activities | 7,112 | 4,660 |
| Cash Flows From Investing Activities: | | |
| Net increase in interest-bearing deposits with banks | — | (4) |
| Purchase of correspondent bank stock | (23) | (495) |
| Purchases of available-for-sale securities | (28,072) | — |
| Maturities of available-for-sale securities | — | 3,000 |
| Principal payments of available-for-sale securities | 7,157 | 6,091 |
| Net decrease (increase) in loans | 25,385 | (12,346) |
| Cash proceeds from sales of other real estate owned | — | 1,062 |
| Investment in limited partnership | — | (1,075) |
| Proceeds from bank owned life insurance | 376 | — |
| Capital expenditures of premises and equipment | (715) | (1,020) |
| Net cash provided by (used in) investing activities | 4,108 | (4,787) |
| Cash Flows From Financing Activities: | | |
| Net increase in demand deposits and savings accounts | 83,102 | 85,653 |
| Net increase (decrease) in time deposits | 8,086 | (36,984) |
| Proceeds from exercise of stock options | — | 6 |
| Dividends on common stock | (3,042) | (1,688) |
| Net cash provided by financing activities | 88,146 | 46,987 |
| Net increase in cash and cash equivalents | 99,366 | 46,860 |
| Cash and cash equivalents at beginning of period | 107,934 | 113,032 |
| Cash and cash equivalents at end of period | $207,300 | $159,892 |

Table of Contents

United Security Bancshares and Subsidiaries - Notes to Consolidated Financial Statements - (Unaudited)

1. Organization and Summary of Significant Accounting and Reporting Policies

The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary United Security Bank (the “Bank”) and one bank subsidiary, USB Investment Trust (the “REIT”) (collectively the “Company” or “USB”). Intercompany accounts and transactions have been eliminated in consolidation.

These unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2017 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

Revenue from Contracts with Customers:

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, “Revenue from Contracts with Customers” (“Topic 606”). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation.

The Company’s primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers. The Company adopted Topic 606 using the modified retrospective method on all contracts not completed as of January 1, 2018. The adoption of Topic 606 did not result in a material change to the accounting for any of the in-scope revenue streams. As such, no cumulative effect adjustment was recorded.

Recently Issued Accounting Standards:

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities” (“ASU 2016-01”). The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. ASU 2016-01 was effective for the Company on January 1, 2018 and resulted in separate classification of equity securities previously included in available for sale securities on the consolidated balance sheets with changes in the fair value of the equity securities captured in the consolidated statements of income. See Note 2 – Investment Securities for disclosures related to equity securities. Adoption of the standard also resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 11 – Fair Value Disclosures for further information regarding the valuation of these loans. Additionally, adoption of the standard resulted in separately recognizing the instrument-specific credit risk associated with the Company's Junior Subordinated Debt. See Note 10 - Junior Subordinated Debt / Trust Preferred Securities for additional information.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). The FASB is issuing this Update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB Accounting Standards Codification® and creating Topic 842, Leases. This Update, along with IFRS 16, Leases, are the results of the FASB's and the International Accounting Standards Board's (IASB's) efforts to meet that objective and improve financial reporting. This ASU will be effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. In July 2018, FASB issued ASU 2018-11, Lease (Topic 842) Targeted Improvements. One of the purposes of this Update was to provide entities with an additional (and optional) transition method to adopt Topic 842. Under this transition method, an entity initially applies the transition requirements in Topic 842 at

Table of Contents

the effective date with the effects of initially applying Topic 842 recognized as a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption. At this time the Company is considering the impact of the transition methods. Additionally, while a complete estimate of the impact of the new leasing standard has not yet been determined, the Company expects a significant new lease asset and related lease liability on the consolidated balance sheet due to the number of leased branches and standalone ATM sites the Company currently has that are accounted for under current operating lease guidance. The Company has selected a vendor to assist in the calculation and implementation of this standard and is in the beginning stages of calculating and assessing the impact of this Update.

In June 2016, FASB issued ASU 2016-13, Financial Instruments- Credit Losses (Topic 326). The FASB is issuing this Update to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The Update requires enhanced disclosures and judgments in estimating credit losses and also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. This amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company has established a project team for the implementation of this new standard. The team has started by working with a vendor to put a new Allowance for Loan Loss software in place and is collecting additional historical data to estimate the impact of this standard. An estimate of the impact of this standard has not yet been determined, however, the impact on the Company's consolidated financial statements is expected to be significant.

In January 2017, FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350). The FASB is issuing this Update to eliminate the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. Instead, entities will record an impairment charge based on the excess of a reporting unit's carrying amount over its fair value. This ASU will be effective for public business entities for annual periods beginning after December 15, 2019 (i.e. calendar periods beginning on January 1, 2020, and interim periods therein. The Company does not expect any impact on the Company's consolidated financial statements resulting from the adoption of this Update.

In March 2017, FASB issued ASU 2017-08 - Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The provisions of the update require premiums recognized upon the purchase of callable debt securities to be amortized to the earliest call date in order to avoid losses recognized upon call. For public business entities that are SEC filers the amendments of the update will become effective in fiscal years beginning after December 15, 2018. The Company does not expect the requirements of this Update to have a material impact on the Company’s financial position, results of operations or cash flows.

In August 2018, FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement. The amendments in this Update modify the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, based on the concepts within FASB's Concepts Statement, including the consideration of costs and benefits. The amendment calls for the removal, modification, and addition of certain disclosure aspects to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures. The amendments of the update will become effective in fiscal years beginning after December 15, 2019. The Company does not expect the requirements of this Update to have a material impact on the Company’s financial position, results of operations or cash flows.

2. Investment Securities

Following is a comparison of the amortized cost and fair value of securities available-for-sale, as of September 30, 2018 and December 31, 2017:
(in 000's)

| September 30, 2018<br>Securities available for sale: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value (Carrying Amount) |
|---|---|---|---|---|
| U.S. Government agencies | $ 34,198 | $ 124 | $ (191 ) | $ 34,131 |
| U.S. Government sponsored entities & agencies collateralized by mortgage obligations | 28,649 | 30 | (707 ) | 27,972 |
| Total securities available for sale | $ 62,847 | $ 154 | $ (898 ) | $ 62,103 |

10

Table of Contents

| (in 000's) December 31, 2017 Securities available for sale: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value (Carrying Amount) |
|---|---|---|---|---|
| U.S. Government agencies | $ 19,683 | $ 312 | $ (41 ) | $ 19,954 |
| U.S. Government sponsored entities & agencies collateralized by mortgage obligations | 22,391 | 56 | (416 ) | 22,031 |
| Total securities available for sale | $ 42,074 | $ 368 | $ (457 ) | $ 41,985 |

The amortized cost and fair value of securities available for sale at September 30, 2018, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns.

| | September 30, 2018 | |
|---|---|---|
| (in 000's) | Amortized Cost | Fair Value (Carrying Amount) |
| Due in one year or less | $— | $ — |
| Due after one year through five years | — | — |
| Due after five years through ten years | 5,860 | 5,843 |
| Due after ten years | 28,338 | 28,288 |
| Collateralized mortgage obligations | 28,649 | 27,972 |
| | $62,847 | $ 62,103 |

There were no realized gains or losses on sales of available-for-sale securities for the three and nine month periods ended September 30, 2018 and September 30, 2017. There were no other-than-temporary impairment losses for the three and nine month periods ended September 30, 2018 and September 30, 2017.

At September 30, 2018, available-for-sale securities with an amortized cost of approximately $48,538,528 (fair value of $47,814,781) were pledged as collateral for FHLB borrowings, securitized deposits, and public funds balances.

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.

Table of Contents

The following summarizes temporarily impaired investment securities:

| (in 000's) | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| September 30, 2018 | Fair Value (Carrying Amount) | Unrealized Losses | Fair Value (Carrying Amount) | Unrealized Losses | Fair Value (Carrying Amount) | Unrealized Losses |
| Securities available for sale: | | | | | | |
| U.S. Government agencies | $17,755 | $ (79) | 7,030 | (112) | $24,785 | $ (191) |
| U.S. Government sponsored entities & agencies collateralized by mortgage obligations | 6,730 | (52) | 17,519 | (655) | 24,249 | (707) |
| Total impaired securities | $24,485 | $ (131) | $24,549 | $ (767) | $49,034 | $ (898) |
| | | | | | | |
| December 31, 2017 | | | | | | |
| Securities available for sale: | | | | | | |
| U.S. Government agencies | $1,728 | $ (3) | $6,625 | $ (38) | $8,353 | $ (41) |
| U.S. Government sponsored entities & agencies collateralized by mortgage obligations | 7,483 | (154) | 13,583 | (262) | 21,066 | (416) |
| Total impaired securities | $9,211 | $ (157) | $20,208 | $ (300) | $29,419 | $ (457) |

Temporarily impaired securities at September 30, 2018, were comprised of ten U.S. government agency securities, and thirteen U.S. government sponsored entities and agencies collateralized by mortgage obligations securities.

The Company evaluates investment securities for other-than-temporary impairment (OTTI) at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under ASC Topic 320, Investments – Debt and Equity Instruments. Certain purchased beneficial interests, including non-agency mortgage-backed securities, asset-backed securities, and collateralized debt obligations, are evaluated under ASC Topic 325-40, Beneficial Interest in Securitized Financial Assets.

In the first segment, the Company considers many factors in determining OTTI, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to the Company at the time of the evaluation.

The second segment of the portfolio uses the OTTI guidance that is specific to purchased beneficial interests including private label mortgage-backed securities. Under this model, the Company compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

Additionally, other-than-temporary-impairment occurs when the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If the Company intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary-impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before

12

Table of Contents

recovery of its amortized cost basis less any current-period loss, the other-than-temporary-impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary-impairment related to the credit loss is recognized in earnings, and is determined based on the difference between the present value of cash flows expected to be collected and the current amortized cost of the security. The amount of the total other-than-temporary-impairment related to other factors shall be recognized in other comprehensive (loss) income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary-impairment recognized in earnings shall become the new amortized cost basis of the investment.

At September 30, 2018, the decline in fair value of the ten U.S. government agency securities, and the thirteen U.S. government sponsored entities and agencies collateralized by mortgage obligations securities is attributable to changes in interest rates, and not credit quality. Because the Company does not have the intent to sell these impaired securities, and it is not more likely than not that it will be required to sell these securities before its anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at September 30, 2018.

As of December 31, 2017, marketable equity securities with a fair value of $3,737,000 were recorded within investment securities available for sale with unrealized losses recorded through comprehensive income and accumulated other comprehensive income. As of January 1, 2018, the Company adopted Accounting Standard Update (“ASU”) 2016-01 and reclassified its marketable equity securities from investments available for sale into a separate component of investment securities. The ASU requires marketable equity securities to be reported at fair value with changes recorded through earnings. As of January 1, 2018, unrealized losses of $184,000 were reclassified from accumulated other comprehensive income to retained earnings.

During the nine months ended September 30, 2018, the Company recognized $114,000 of unrealized losses related to equity securities held at September 30, 2018 in the consolidated statements of income. For the quarter ended September 30, 2018, the Company recognized $35,000 of unrealized losses related to equity securities held at September 30, 2018 in the consolidated statements of income. The resulting impact on basic and diluted earnings per share for the quarter and nine months ended September 30, 2018 is immaterial.

The Company had no held-to-maturity or trading securities at September 30, 2018 or December 31, 2017.

## 3. Loans

Loans are comprised of the following:

| (in 000's) | September 30, 2018 | December 31, 2017 |
|---|---|---|
| Commercial and business loans | $ 54,639 | $ 46,065 |
| Government program loans | 884 | 961 |
| Total commercial and industrial | 55,523 | 47,026 |
| Real estate – mortgage: | | |
| Commercial real estate | 212,639 | 221,032 |
| Residential mortgages | 68,263 | 84,804 |
| Home improvement and home equity loans | 333 | 457 |
| Total real estate mortgage | 281,235 | 306,293 |
| Real estate construction and development | 109,154 | 122,970 |
| Agricultural | 59,655 | 59,481 |
| Installment and student loans | 71,548 | 65,581 |
| Total loans | $ 577,115 | $ 601,351 |

The Company's loans are predominantly in the San Joaquin Valley and the greater Oakhurst/East Madera County area, as well as the Campbell area of Santa Clara County. Although the Company does participate in loans with other financial institutions, they are primarily in the state of California.

Commercial and industrial loans represent 9.6% of total loans at September 30, 2018 and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide working capital, financing for the purchase of manufacturing plants and equipment, or

Table of Contents

funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases, or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 48.7% of total loans at September 30, 2018, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans generally comes from the cash flow of the borrower and or guarantor(s).

- Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and non-income producing commercial properties, including: office buildings, shopping centers; apartments and motels; owner occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.

- Residential mortgage loans are provided to individuals to finance or refinance single-family residences. Residential mortgages are not a primary business line offered by the Company, and a majority are conventional mortgages that were purchased as a pool.

- Home Improvement and Home Equity loans comprise a relatively small portion of total real estate mortgage loans. Home equity loans are generally secured by junior trust deeds, but may be secured by 1st trust deeds.

Real estate construction and development loans, representing 18.9% of total loans at September 30, 2018, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for future development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans generally comes from long-term mortgages with other lending institutions obtained at completion of the project or from the sale of the constructed homes to individuals.

Agricultural loans represent 10.3% of total loans at September 30, 2018 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans, including student loans, represent 12.4% of total loans at September 30, 2018 and generally consist of student loans, loans to individuals for household, family and other personal expenditures, automobiles or other consumer items. Included in installment loans are $65,659,000 in unsecured student loans made to medical and pharmacy school students. The medical student loans are made to US citizens attending medical schools in the US and Antigua, while the pharmacy student loans are made to pharmacy students attending pharmacy school in the US. Upon graduation the loan is automatically placed on deferment for 6 months. This may be extended up to 48 months for graduates enrolling in Internship, Medical Residency or Fellowship. As approved the student may receive additional deferment for hardship or administrative reasons in the form of forbearance for a maximum of 24 months throughout the life of the loan. Accrued interest on loans that have not entered repayment status totaled $7,183,000 at September 30, 2018. At September 30, 2018 there were 332 loans within repayment, deferment, and forbearance which represented $6,896,000, $1,005,000, and $2,680,000 in outstanding balances, respectively. Prior to June 2018, student loans were insured through a Surety Bond issued by ReliaMax Surety Company and provided the Company reasonable expectation of collection. In June 2018, ReliaMax Surety Company was declared insolvent by the South Dakota Division of Insurance and is now in liquidation. As a result of the insolvency, the Company's student loan portfolio is no longer insured.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At September 30, 2018 and December 31, 2017, these financial instruments include commitments to extend credit of $116,096,000 and $99,958,000, respectively, and standby letters of credit of $1,183,000 and $2,058,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the consolidated balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

The Company’s exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company uses the same credit policies as it does for on-balance sheet instruments.

Table of Contents

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. A majority of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

Standby letters of credit are generally unsecured and are 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 loans to customers.

During the second quarter of 2018, the Bank entered into a Small Business Administration (SBA) 504 Loan Forward Purchase Commitment to buy a one hundred percent (100%) interest in up to $30 million, first mortgage, California SBA 504 loans on a flow basis with servicing released by the Seller.

Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors.

The following is a summary of delinquent loans at September 30, 2018 (in 000's):

| September 30, 2018 | Loans 30-60 Days Past Due | Loans 61-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|---|---|---|---|---|---|---|---|
| Commercial and business loans | $— | $— | $— | $— | $54,639 | $54,639 | $ — |
| Government program loans | — | — | — | — | 884 | 884 | — |
| Total commercial and industrial | — | — | — | — | 55,523 | 55,523 | — |
| Commercial real estate loans | — | 393 | — | 393 | 212,246 | 212,639 | — |
| Residential mortgages | 946 | — | — | 946 | 67,317 | 68,263 | — |
| Home improvement and home equity loans | — | — | — | — | 333 | 333 | — |
| Total real estate mortgage | 946 | 393 | — | 1,339 | 279,896 | 281,235 | — |
| Real estate construction and development loans | — | — | 8,825 | 8,825 | 100,329 | 109,154 | — |
| Agricultural loans | — | 45 | — | 45 | 59,610 | 59,655 | — |
| Installment and student loans | 673 | 496 | — | 1,169 | 70,186 | 71,355 | 417 |
| Overdraft protection lines | — | — | — | — | 36 | 36 | — |
| Overdrafts | — | — | — | — | 157 | 157 | — |
| Total installment and student loans | 673 | 496 | — | 1,169 | 70,379 | 71,548 | 417 |
| Total loans | $1,619 | $934 | $8,825 | $11,378 | $565,737 | $577,115 | $ 417 |

Table of Contents

The following is a summary of delinquent loans at December 31, 2017 (in 000's):

| December 31, 2017 | Loans 30-60 Days Past Due | Loans 61-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|---|---|---|---|---|---|---|---|
| Commercial and business loans | $ — | $ — | $ 212 | $ 212 | $ 45,853 | $ 46,065 | $ — |
| Government program loans | — | — | — | — | 961 | 961 | — |
| Total commercial and industrial | — | — | 212 | 212 | 46,814 | 47,026 | — |
| Commercial real estate loans | 779 | — | — | 779 | 220,253 | 221,032 | — |
| Residential mortgages | — | — | 94 | 94 | 84,710 | 84,804 | — |
| Home improvement and home equity loans | — | — | — | — | 457 | 457 | — |
| Total real estate mortgage | 779 | — | 94 | 873 | 305,420 | 306,293 | — |
| Real estate construction and development loans | — | — | 360 | 360 | 122,610 | 122,970 | 360 |
| Agricultural loans | — | — | — | — | 59,481 | 59,481 | — |
| Installment and student loans | — | — | — | — | 65,446 | 65,446 | 125 |
| Overdraft protection lines | — | — | — | — | 38 | 38 | — |
| Overdrafts | — | — | — | — | 97 | 97 | — |
| Total installment and student loans | — | — | — | — | 65,581 | 65,581 | 125 |
| Total loans | $ 779 | $ — | $ 666 | $ 1,445 | $ 599,906 | $ 601,351 | $ 485 |

Nonaccrual Loans

Commercial, construction and commercial real estate loans are placed on nonaccrual status under the following circumstances:

- When there is doubt regarding the full repayment of interest and principal.

- When principal and/or interest on the loan has been in default for a period of 90-days or more, unless the asset is both well secured and in the process of collection that will result in repayment in the near future.

- When the loan is identified as having loss elements and/or is risk rated "8" Doubtful.

Other circumstances which jeopardize the ultimate collectability of the loan including certain troubled debt restructurings, identified loan impairment, and certain loans to facilitate the sale of OREO.

Loans meeting any of the preceding criteria are placed on nonaccrual status and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

All loans, outside of student loans, where principal or interest is due and unpaid for 90 days or more are placed on nonaccrual and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income. Student loans are generally charged off at the end of the month during which an account becomes 120 days contractually past due. Accrued but unpaid interest related to charged off student loans is reversed and charged against interest income.

When a loan is placed on nonaccrual status and subsequent payments of interest (and principal) are received, the interest received may be accounted for in two separate ways.

Cost recovery method: If the loan is in doubt as to full collection, the interest received in subsequent payments is diverted from interest income to a valuation reserve and treated as a reduction of principal for financial reporting purposes.

Cash basis: This method is only used if the recorded investment or total contractual amount is expected to be fully collectible, under which circumstances the subsequent payments of interest are credited to interest income as received.

Table of Contents

Loans on non-accrual status are usually not returned to accrual status unless all delinquent principal and/or interest has been brought current, there is no identified element of loss, and current and continued satisfactory performance is expected (loss of the contractual amount not the carrying amount of the loan). Return to accrual is generally demonstrated through the timely receipt of at least six monthly payments on a loan with monthly amortization.

Nonaccrual loans totaled $12,106,000 and $5,296,000 at September 30, 2018 and December 31, 2017, respectively. Two loans were added to nonaccrual during the quarter ended June 30, 2018. Those loans, totaling $8,825,000, were made to the same borrower and are well-secured by real estate collateral. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at September 30, 2018 or December 31, 2017.

The following is a summary of nonaccrual loan balances at September 30, 2018 and December 31, 2017 (in 000's).

| | September 30, 2018 | December 31, 2017 |
|---|---|---|
| Commercial and business loans | $ — | $ 212 |
| Government program loans | — | — |
| Total commercial and industrial | — | 212 |
| | | |
| Commercial real estate loans | 393 | 454 |
| Residential mortgages | — | 288 |
| Home improvement and home equity loans | — | — |
| Total real estate mortgage | 393 | 742 |
| | | |
| Real estate construction and development loans | 11,713 | 4,342 |
| Agricultural loans | — | — |
| | | |
| Installment and student loans | — | — |
| Overdraft protection lines | — | — |
| Overdrafts | — | — |
| Total installment and student loans | — | — |
| Total loans | $ 12,106 | $ 5,296 |

Impaired Loans

A loan is considered impaired when based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement.

The Company applies its normal loan review procedures in making judgments regarding probable losses and loan impairment. The Company evaluates for impairment those loans on nonaccrual status, graded doubtful, graded substandard or those that are troubled debt restructures. The primary basis for inclusion in impaired status under generally accepted accounting pronouncements is that it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement.

A loan is not considered impaired if there is merely an insignificant delay or shortfall in the amounts of payments and the Company expects to collect all amounts due, including interest accrued, at the contractual interest rate for the period of the delay.

Review for impairment does not include large groups of smaller balance homogeneous loans that are collectively evaluated to estimate the allowance for loan losses. The Company's present allowance for loan losses methodology, including migration analysis, captures required reserves for these loans in the formula allowance.

For loans determined to be impaired, the Company evaluates impairment based upon either the fair value of underlying collateral, discounted cash flows of expected payments, or observable market price.

- For loans secured by collateral including real estate and equipment, the fair value of the collateral less selling costs will determine the carrying value of the loan. The difference between the recorded investment in the loan and the fair value,

Table of Contents

less selling costs, determines the amount of impairment. The Company uses the measurement method based on fair value of collateral when the loan is collateral dependent and foreclosure is probable. For loans that are not considered collateral dependent, a discounted cash flow methodology is used.

- The discounted cash flow method of measuring the impairment of a loan is used for impaired loans that are not considered to be collateral dependent. Under this method, the Company assesses both the amount and timing of cash flows expected from impaired loans. The estimated cash flows are discounted using the loan's effective interest rate. The difference between the amount of the loan on the Bank's books and the discounted cash flow amounts determines the amount of impairment to be provided. This method is used for most of the Company’s troubled debt restructurings or other impaired loans where some payment stream is being collected.

- The observable market price method of measuring the impairment of a loan is only used by the Company when the sale of loans or a loan is in process.

The method for recognizing interest income on impaired loans is dependent on whether the loan is on nonaccrual status or is a troubled debt restructure. For income recognition, the existing nonaccrual and troubled debt restructuring policies are applied to impaired loans. Generally, except for certain troubled debt restructurings which are performing under the restructure agreement, the Company does not recognize interest income received on impaired loans, but reduces the carrying amount of the loan for financial reporting purposes.

Loans other than certain homogeneous loan portfolios are reviewed on a quarterly basis for impairment. Impaired loans are written down to estimated realizable values by the establishment of specific reserves for loan utilizing the discounted cash flow method, or charge-offs for collateral-based impaired loans, or those using observable market pricing.

Table of Contents

The following is a summary of impaired loans at September 30, 2018 (in 000's).

| September 30, 2018 | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance (1) | Recorded Investment With Allowance (1) | Total Recorded Investment | Related Allowance | Average Recorded Investment (2) | Interest Recognized (2) |
|---|---|---|---|---|---|---|---|
| Commercial and business loans | $ 2,726 | $ 503 | $ 2,235 | $ 2,738 | $ 633 | $ 3,063 | $ 139 |
| Government program loans | 300 | 301 | — | 301 | — | 245 | 15 |
| Total commercial and industrial | 3,026 | 804 | 2,235 | 3,039 | 633 | 3,308 | 154 |
| | | | | | | | |
| Commercial real estate loans | 1,310 | 393 | 921 | 1,314 | 396 | 1,385 | 47 |
| Residential mortgages | 2,202 | 394 | 1,816 | 2,210 | 68 | 2,505 | 89 |
| Home improvement and home equity loans | — | — | — | — | — | — | — |
| Total real estate mortgage | 3,512 | 787 | 2,737 | 3,524 | 464 | 3,890 | 136 |
| | | | | | | | |
| Real estate construction and development loans | 11,713 | 11,713 | — | 11,713 | — | 8,514 | 268 |
| Agricultural loans | 909 | — | 914 | 914 | 620 | 1,063 | 63 |
| | | | | | | | |
| Installment and student loans | 52 | 52 | — | 52 | — | 50 | 4 |
| Overdraft protection lines | — | — | — | — | — | — | — |
| Overdrafts | — | — | — | — | — | — | — |
| Total installment and student loans | 52 | 52 | — | 52 | — | 50 | 4 |
| Total impaired loans | $ 19,212 | $ 13,356 | $ 5,886 | $ 19,242 | $ 1,717 | $ 16,825 | $ 625 |

(1) The recorded investment in loans includes accrued interest receivable of $30.
(2) Information is based on the nine month period ended September 30, 2018.

Table of Contents

The following is a summary of impaired loans at December 31, 2017 (in 000's).

| December 31, 2017 | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance (1) | Recorded Investment With Allowance (1) | Total Recorded Investment | Related Allowance | Average Recorded Investment (2) | Interest Recognized (2) |
|---|---|---|---|---|---|---|---|
| Commercial and business loans | $ 3,255 | $ 381 | $ 2,887 | $ 3,268 | $ 534 | $ 3,791 | $ 229 |
| Government program loans | 49 | 50 | — | 50 | — | 219 | 5 |
| Total commercial and industrial | 3,304 | 431 | 2,887 | 3,318 | 534 | 4,010 | 234 |
| | | | | | | | |
| Commercial real estate loans | 1,233 | — | 1,245 | 1,245 | 385 | 1,138 | 79 |
| Residential mortgages | 3,040 | 1,199 | 1,852 | 3,051 | 103 | 2,745 | 142 |
| Home improvement and home equity loans | — | — | — | — | — | — | — |
| Total real estate mortgage | 4,273 | 1,199 | 3,097 | 4,296 | 488 | 3,883 | 221 |
| | | | | | | | |
| Real estate construction and development loans | 5,951 | 5,972 | — | 5,972 | — | 6,660 | 418 |
| Agricultural loans | 1,200 | 1 | 1,203 | 1,204 | 866 | 1,179 | 48 |
| | | | | | | | |
| Installment and student loans | — | — | — | — | — | 241 | — |
| Overdraft protection lines | — | — | — | — | — | — | — |
| Overdrafts | — | — | — | — | — | — | — |
| Total installment and student loans | — | — | — | — | — | 241 | — |
| Total impaired loans | $ 14,728 | $ 7,603 | $ 7,187 | $ 14,790 | $ 1,888 | $ 15,973 | $ 921 |

(1) The recorded investment in loans includes accrued interest receivable of $62.
(2) Information is based on the twelve month period ended December 31, 2017.

In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructurings for which the loan is performing under the current contractual terms for a reasonable period of time, income is recognized under the accrual method.

The average recorded investment in impaired loans for the quarters ended September 30, 2018 and 2017 was $19,469,000 and $15,681,000, respectively. Interest income recognized on impaired loans for the quarters ended September 30, 2018 and 2017 was approximately $173,000 and $192,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately $64,000 and $70,000 for the quarters ended September 30, 2018 and 2017, respectively.

The average recorded investment in impaired loans for the nine months ended September 30, 2018 and 2017 was $16,825,000 and $16,366,000, respectively. Interest income recognized on impaired loans for the nine months ended September 30, 2018 and 2017 was approximately $625,000 and $738,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately $277,000 and $260,000 for the nine months ended September 30, 2018 and 2017, respectively.

Table of Contents

Troubled Debt Restructurings

In certain circumstances, when the Company grants a concession to a borrower as part of a loan restructuring, the restructuring is accounted for as a troubled debt restructuring (TDR). TDRs are reported as a component of impaired loans.

A TDR is a type of restructuring in which the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession (either imposed by court order, law, or agreement between the borrower and the Bank) to the borrower that it would not otherwise consider. Although the restructuring may take different forms, the Company's objective is to maximize recovery of its investment by granting relief to the borrower.

A TDR may include, but is not limited to, one or more of the following:

- A transfer from the borrower to the Company of receivables from third parties, real estate, other assets, or an equity interest in the borrower is granted to fully or partially satisfy the loan.

- A modification of terms of a debt such as one or a combination of:

The reduction (absolute or contingent) of the stated interest rate.
The extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
The reduction (absolute or contingent) of the face amount or maturity amount of debt as stated in the instrument or agreement.
The reduction (absolute or contingent) of accrued interest.

For a restructured loan to return to accrual status there needs to be, among other factors, at least 6 months successful payment history and continued satisfactory performance is expected. To this end, the Company typically performs a financial analysis of the credit to determine whether the borrower has the ability to continue to meet payments over the remaining life of the loan. This includes, but is not limited to, a review of financial statements and cash flow analysis of the borrower. Only after determination that the borrower has the ability to perform under the terms of the loans, will the restructured credit be considered for accrual status. Although the Company does not have a policy which specifically addresses when a loan may be removed from TDR classification, as a matter of practice, loans classified as TDRs generally remain classified as such until the loan either reaches maturity or its outstanding balance is paid off.

The following tables illustrates TDR additions for the periods indicated:

| ($ in 000's) | Three Months Ended September 30, 2018<br>Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Contracts which Defaulted During Period | Recorded Investment on Defaulted TDRs |
|---|---|---|---|---|---|
| Troubled Debt Restructurings | | | | | |
| Commercial and business loans | — | $ — | $ — | — | $ — |
| Government program loans | — | — | — | — | — |
| Commercial real estate term loans | — | — | — | 1 | 393 |
| Single family residential loans | — | — | — | — | — |
| Home improvement and home equity loans | — | — | — | — | — |

| | | | | |
|---|---|---|---|---|
| Real estate construction and development loans | — | — | — | — |
| Agricultural loans | — | — | — | — |
| Installment and student loans | — | — | — | — |
| Overdraft protection lines | — | — | — | — |
| Total loans | $ — | $ — | $ — 1 | $ 393 |

21

Table of Contents

| ($ in 000's) | Three Months Ended September 30, 2017 | | | | |
|---|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Contracts which Defaulted During Period | Recorded Investment on Defaulted TDRs |
| Troubled Debt Restructurings | | | | | |
| Commercial and business loans | — | $ — | $ — | — | $ — |
| Government program loans | — | — | — | — | — |
| Commercial real estate term loans | — | — | — | — | — |
| Single family residential loans | 1 | 167 | 167 | — | — |
| Home improvement and home equity loans | — | — | — | — | — |
| Real estate construction and development loans | — | — | — | — | — |
| Agricultural loans | 1 | 587 | 587 | — | — |
| Installment and student loans | — | — | — | — | — |
| Overdraft protection lines | — | — | — | — | — |
| Total loans | 2 | $ 754 | $ 754 | — | $ — |

| ($ in 000's) | Nine Months Ended September 30, 2018 | | | | |
|---|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Contracts which Defaulted During Period | Recorded Investment on Defaulted TDRs |
| Troubled Debt Restructurings | | | | | |
| Commercial and business loans | — | $ — | $ — | — | $ — |
| Government program loans | — | — | — | — | — |
| Commercial real estate term loans | — | — | — | 1 | 393 |
| Single family residential loans | — | — | — | — | — |
| Home improvement and home equity loans | — | — | — | — | — |
| Real estate construction and development loans | — | — | — | 1 | 310 |
| Agricultural loans | — | — | — | — | — |
| Installment and student loans | — | — | — | — | — |
| Overdraft protection lines | — | — | — | — | — |
| Total loans | — | $ — | $ — | 2 | $ 703 |

Table of Contents

| ($ in 000's) | Nine Months Ended September 30, 2017 Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Contracts which Defaulted During Period | Recorded Investment on Defaulted TDRs |
|---|---|---|---|---|---|
| Troubled Debt Restructurings | | | | | |
| Commercial and business loans | 1 | $ 69 | $ 69 | — | $ — |
| Government program loans | 1 | 178 | 178 | — | — |
| Commercial real estate term loans | — | — | — | — | — |
| Single family residential loans | 2 | 404 | 404 | — | — |
| Home improvement and home equity loans | — | — | — | — | — |
| Real estate construction and development loans | 1 | 790 | 790 | — | — |
| Agricultural loans | 2 | 1,437 | 1,437 | — | — |
| Installment and student loans | — | — | — | — | — |
| Overdraft protection lines | — | — | — | — | — |
| Total loans | 7 | $ 2,878 | $ 2,878 | — | $ — |

The Company makes various types of concessions when structuring TDRs including rate discounts, payment extensions, and other-than-temporary forbearance. At September 30, 2018, the Company had 17 restructured loans totaling $7,402,000 as compared to 25 restructured loans totaling $11,362,000 at December 31, 2017.

The following tables summarize TDR activity by loan category for the quarters ended September 30, 2018 and September 30, 2017 (in 000's).

| Three Months Ended September 30, 2018 | Commercial and Industrial | Commercial Real Estate | Residential Mortgages | Home Improvement and Home Equity | Real Estate Construction Development | Agricultural | Installment & Student Loans | Total |
|---|---|---|---|---|---|---|---|---|
| Beginning balance | $ 110 | $ 1,362 | $ 2,219 | $ — | $ 2,939 | $ 1,010 | $ — | $ 7,640 |
| Additions | — | — | — | — | — | — | — | — |
| Principal (reductions) additions | (17) | (6) | (16) | — | (51) | (102) | — | (192) |
| Charge-offs | — | (46) | — | — | — | — | — | (46) |
| Ending balance | $ 93 | $ 1,310 | $ 2,203 | $ — | $ 2,888 | $ 908 | $ — | $ 7,402 |
| Allowance for loan loss | $ — | $ 396 | $ 68 | $ — | $ — | $ 620 | $ — | $ 1,084 |
| Defaults | $ — | $ (312) | $ — | $ — | $ — | $ — | $ — | $ (312) |

Table of Contents

| Three Months Ended September 30, 2017 | Commercial and Industrial | Commercial Real Estate | Residential Mortgages | Home Improvement and Home Equity | Real Estate Construction Development | Agricultural | Installment & Student Loans | Total |
|---|---|---|---|---|---|---|---|---|
| Beginning balance | $ 1,055 | $ 1,062 | $ 2,573 | $ — | $ 6,868 | $ 400 | $ — | $ 11,958 |
| Additions | — | — | 167 | — | — | 587 | — | 754 |
| Principal reductions | (425) | 85 | (52) | — | (70) | (100) | — | (562) |
| Charge-offs | — | — | — | — | — | — | — | |
| Ending balance | $ 630 | $ 1,147 | $ 2,688 | $ — | $ 6,798 | $ 887 | $ — | $ 12,150 |
| Allowance for loan loss | $ 15 | $ 221 | $ 206 | $ — | $ — | $ 743 | $ — | $ 1,185 |
| Defaults | $ — | $ — | $ — | $ — | $ — | $ — | $ — | $ — |

The following tables summarize TDR activity by loan category for the nine months ended September 30, 2018 and September 30, 2017 (in 000's).

| Nine Months Ended September 30, 2018 | Commercial and Industrial | Commercial Real Estate | Residential Mortgages | Home Improvement and Home Equity | Real Estate Construction Development | Agricultural | Installment & Student Loans | Total |
|---|---|---|---|---|---|---|---|---|
| Beginning balance | $ 436 | $ 1,233 | $ 2,542 | $ — | $ 5,951 | $ 1,200 | $ — | $ 11,362 |
| Additions | — | — | — | — | — | — | — | — |
| Principal (reductions) additions | (280) | 123 | (339) | — | (3,063) | (292) | — | (3,851) |
| Charge-offs | (63) | (46) | — | — | — | — | — | (109) |
| Ending balance | $ 93 | $ 1,310 | $ 2,203 | $ — | $ 2,888 | $ 908 | $ — | $ 7,402 |
| Allowance for loan loss | $ — | $ 396 | $ 68 | $ — | $ — | $ 620 | $ — | $ 1,084 |
| Defaults | $ — | $ (312) | $ — | $ — | $ (310) | $ — | $ — | $ (622) |

| Nine Months Ended September 30, 2017 | Commercial and Industrial | Commercial Real Estate | Residential Mortgages | Home Improvement and Home Equity | Real Estate Construction Development | Agricultural | Installment & Student Loans | Total |
|---|---|---|---|---|---|---|---|---|
| Beginning balance | $ 1,356 | $ 1,454 | $ 2,368 | $ — | $ 6,267 | $ — | $ 965 | $ 12,410 |
| Additions | 247 | — | 404 | — | 790 | 1,437 | — | 2,878 |
| Principal additions (reductions) | (963) | (307) | (84) | — | (259) | (550) | (965) | (3,128) |
| Charge-offs | (10) | — | — | — | — | — | — | (10) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Ending balance | $ 630 | $ 1,147 | $ 2,688 | $ — | $ 6,798 | $ 887 | $ — | $12,150 |
| Allowance for loan loss | $ 15 | $ 221 | $ 206 | $ — | $ — | $ 743 | $ — | $1,185 |
| Defaults | $ — | $ — | $ — | $ — | $ — | $ — | $ | |