SIERRA BANCORP
Form 10-Q
November 07, 2016

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES

EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2016

Commission file number: 000-33063

Sierra Bancorp

(Exact name of Registrant as specified in its charter)

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

86 North Main Street, Porterville, California 93257

(Address of principal executive offices) (Zip Code)

(559) 782-4900

(Registrant's telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes R No £

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes R No £

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

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

Common stock, no par value, 13,791,101 shares outstanding as of November 1, 2016

FORM 10-Q

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PART I – FINANCIAL INFORMATION

Item 1 – Financial Statements

SIERRA BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

ASSETS	September 30, 2016 (unaudited)	December 31, 2015 (audited)
Cash and due from banks	$56,903	$46,627
Interest-bearing deposits in banks	8,539	1,996
Total cash & cash equivalents	65,442	48,623
Securities available for sale	535,580	507,582
Loans and leases:		
Gross loans and leases	1,256,330	1,132,856
Allowance for loan and lease losses	(9,880)	(10,423)
Deferred loan and lease fees, net	2,956	2,169
Net loans and leases	1,249,406	1,124,602
Premises and equipment, net	28,781	21,990
Foreclosed assets	2,782	3,193
Company owned life insurance	44,191	44,140
Goodwill	7,932	6,908
Other intangible assets, net	2,909	930
Other assets	36,217	38,569
	$1,973,240	$1,796,537
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$498,391	$432,251
Interest bearing	1,135,440	1,032,377
Total deposits	1,633,831	1,464,628
Federal funds purchased and repurchase agreements	9,270	9,405
Short-term borrowings	71,600	75,300
Long-term borrowings	-	2,000
Junior subordinated debentures	34,365	30,928
Other liabilities	15,646	23,936
Total Liabilities	1,764,712	1,606,197

Commitments and contingent liabilities (Note 8)

Shareholders’ equity		
Common stock, no par value; 24,000,000 shares authorized; 13,789,501 and 13,254,088 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	72,370	62,404
Additional paid in capital	2,764	2,689
Retained earnings	128,699	122,701
Accumulated other comprehensive income, net	4,695	2,546
Total shareholders’ equity	208,528	190,340
	$1,973,240	$1,796,537

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

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SIERRA BANCORP
CONSOLIDATED STATEMENTS OF INCOME

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

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Interest and dividend income				
Loans and leases, including fees	$15,121	$12,924	$41,360	$38,124
Taxable securities	1,879	1,847	6,114	6,191
Tax-exempt securities	765	746	2,225	2,202
Federal funds sold and other	29	7	61	26
Total interest income	17,794	15,524	49,760	46,543
Interest expense				
Deposits	575	452	1,573	1,345
Short-term borrowings	51	12	107	43
Long-term borrowings	-	2	-	9
Subordinated debentures	261	181	663	533
Total interest expense	887	647	2,343	1,930
Net Interest Income	16,907	14,877	47,417	44,613
Provision for loan losses	-	-	-	-
Net interest income after provision for loan losses	16,907	14,877	47,417	44,613
Non-interest income				
Service charges on deposits	2,686	2,611	7,535	6,880
Net gains on sale of securities available-for-sale	90	108	212	431
Other income	2,215	1,542	6,112	5,611
Total non-interest income	4,991	4,261	13,859	12,922
Other operating expense				
Salaries and employee benefits	6,866	5,904	20,355	18,924
Occupancy and equipment	2,063	1,834	5,680	5,160
Other	7,192	4,547	17,280	14,412
Total other operating expense	16,121	12,285	43,315	38,496
Income before taxes	5,777	6,853	17,961	19,039
Provision for income taxes	1,848	2,443	5,911	6,335
Net income	$3,929	$4,410	$12,050	$12,704
PER SHARE DATA				
Book value	$15.12	$14.12	$15.12	$14.12
Cash dividends	$0.12	$0.11	$0.36	$0.31
Earnings per share basic	$0.28	$0.33	$0.90	$0.94
Earnings per share diluted	$0.28	$0.33	$0.89	$0.93
Average shares outstanding, basic	13,790,107	13,358,895	13,446,567	13,531,370
Average shares outstanding, diluted	13,904,460	13,482,364	13,560,716	13,656,747

Total shareholder equity (in thousands)	$208,528	$187,052	$208,528	$187,052
Shares outstanding	13,789,501	13,248,048	13,789,501	13,248,048
Dividends Paid	$1,666,175	$1,474,639	$4,850,886	$4,205,218

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

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SIERRA BANCORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in thousands, unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Net Income	$3,929	$4,410	$12,050	$12,704
Other comprehensive income, before tax:				
Unrealized gains on securities:				
Unrealized holding (losses) gains arising during period	(674)	1,284	3,813	(1,225)
Less: reclassification adjustment for gains [(1)] included in net income	(90)	(108)	(212)	(431)
Other comprehensive (loss) income, before tax	(764)	1,176	3,601	(1,656)
Income tax expense (benefit) related to items of other comprehensive income (loss), net of tax	362	(494)	(1,452)	632
Other comprehensive income (loss) gain	(402)	682	2,149	(1,024)
Comprehensive Income	$3,527	$5,092	$14,199	$11,680

(1) Amounts are included in net gains on investment securities available-for-sale on the Consolidated Statements of Income in non-interest revenue. Income tax expense associated with the reclassification adjustment for the three months ended September 30, 2016 and 2015 was $38 thousand and $45 thousand respectively. Income tax expense associated with the reclassification adjustment for the nine months ended September 30, 2016 and 2015 was $89 thousand and $181 thousand respectively.

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

SIERRA BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands, unaudited)

	Nine months ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	$12,050	$12,704
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of securities	(212)	(431)
Gain on sales of loans	-	(6)
Loss on disposal of fixed assets	-	62
Loss (gain) on sale on foreclosed assets	3	(166)
Writedowns on foreclosed assets	275	193
Share-based compensation expense	180	33
Provision for loan losses	-	-
Depreciation	1,880	1,694
Net accretion on purchased loans	(391)	(634)
Net amortization on securities premiums and discounts	5,208	5,217
Decrease in unearned net loan fees	787	299
Increase in cash surrender value of life insurance policies	(51)	(686)
Proceeds from sale of loans	-	323
Increase in loans held-for-sale	-	(317)
Decrease in interest receivable and other assets	3,593	3,845
Increase in other liabilities	(8,995)	(4,730)
Deferred Income Tax Provision (benefit)	1,998	(1,182)
Excess tax benefit from equity based compensation	93	92
Net cash provided by operating activities	16,418	16,310
Cash flows from investing activities:		
Maturities of securities available for sale	1,195	580
Proceeds from sales/calls of securities available for sale	23,753	24,408
Purchases of securities available for sale	(103,334)	(97,899)
Principal pay downs on securities available for sale	72,463	68,753
Purchases of FHLB stock	-	(504)
Proceeds from redemption of FHLB stock	(960)	-
Net increase in loans receivable, net	(31,785)	(84,776)
Purchases of premises and equipment, net	(4,016)	(2,136)
Proceeds from sale premises and equipment	1,204	56
Proceeds from sales of foreclosed assets	982	1,454
Cash acquired in bank acquisition	15,502	-

Net cash used in investing activities	(24,996)	(90,064)
Cash flows from financing activities:		
Increase in deposits	40,165	62,419
(Decrease) increase in borrowed funds	(8,200)	19,300
Increase in Fed funds purchased	2,500	-
Decrease (increase) in repurchase agreements	(2,635)	2,864
Cash dividends paid	(4,851)	(4,205)
Repurchases of common stock	(1,723)	(7,956)
Stock options exercised	234	317
Proceeds from issuance of subordinated debt	-	-
Excess tax benefit from equity based compensation	(93)	(92)
Net cash provided by financing activities	25,397	72,647
Increase (decrease) in cash and due from banks	16,819	(1,107)
Cash and cash equivalents		
Beginning of period	48,623	50,095
End of period	$65,442	$48,988

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

Sierra Bancorp

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2016

(Unaudited)

Note 1 – The Business of Sierra Bancorp

Sierra Bancorp (the "Company") is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the "Bank"), and has been the Bank's sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. As of September 30, 2016, the Company's only other subsidiaries were Sierra Statutory Trust II, Sierra Capital Trust III, and Coast Bancorp Statutory Trust II, which were formed solely to facilitate the issuance of capital trust pass-through securities ("TRUPS"). Pursuant to the Financial Accounting Standards Board ("FASB") standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the Company's financial statements. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

Bank of the Sierra is a California state-chartered bank also headquartered in Porterville, California. The Bank was incorporated in September 1977, and opened for business in January 1978 as a one-branch bank with $1.5 million in capital and eleven employees. Our growth in the ensuing years has been largely organic, but also includes three whole-bank acquisitions: Sierra National Bank in the year 2000, Santa Clara Valley Bank in 2014, and Coast National Bank in July of 2016 (see Note 13 to the financial statements, Acquisition, for details on the acquisition of Coast Bancorp ["Coast"], the holding company for Coast National Bank, by Sierra Bancorp). With our latest acquisition the Bank now operates 33 full-service branches and a loan production office, and offers a full range of retail and commercial banking services in California's South Central Valley and neighboring communities, the Central Coast, and select Southern California locations including Ventura County and the Santa Clarita Valley. Our most recent branching activity occurred in the second quarter of 2016, with the opening of a de novo branch in Sanger, California and the purchase of a competitor bank's Porterville branch which was consolidated into our main office (see Note 14 to the financial statements, Recent Developments, for details on the branch acquisition). Furthermore, we have received regulatory approvals for another branch in Bakersfield, California, which is under construction and should be ready to commence operations by the first quarter of 2017, as well as a proposed de novo branch in Pismo Beach, California, although the timing for that branch opening remains uncertain. In addition to our stand-alone offices the Bank has specialized lending units which include a real estate industries center, an agricultural credit center, and an SBA lending unit. We also have ATMs at all branch locations and offsite ATMs at six different non-branch locations. We were close to $2.0 billion in total assets as of September 30, 2016, and for the past several years have claimed the distinction of being the largest bank headquartered in the South San Joaquin Valley. The Bank's deposit accounts are insured by the Federal Deposit Insurance Corporation ("FDIC") up to maximum insurable amounts.

Note 2 – Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in a condensed format, and therefore do not include all of the information and footnotes required by U.S. generally accepted accounting principles ("GAAP") for complete financial statements. The information furnished in these interim statements reflects all adjustments that are, in the opinion of Management, necessary for a fair statement of the results for such periods. Such adjustments can generally be considered as normal and recurring unless otherwise disclosed in this Form 10-Q. In preparing the accompanying financial statements, Management has taken subsequent events into consideration and recognized them where appropriate. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter, or for the full year. Certain amounts reported for 2015 have been reclassified to be consistent with the reporting for 2016. The interim financial information should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the Securities and Exchange Commission (the "SEC").

Note 3 – Current Accounting Developments

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU is the result of a joint project initiated by the FASB and the International Accounting Standards Board (IASB) to clarify the principles for recognizing revenue, and to develop common revenue standards and disclosure requirements that would: (1) remove inconsistencies and weaknesses in revenue requirements; (2) provide a more robust framework for addressing revenue issues; (3) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; (4) provide more useful information to users of financial statements through improved disclosures; and (5) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required with regard to contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. This ASU is effective for annual reporting periods beginning after December 15, 2017, including interim periods therein, with early adoption permitted for reporting periods beginning after December 15, 2016. The Company does not expect to adopt this guidance early and is currently evaluating the potential effects of the guidance on its financial statements and disclosures.

In June 2014 the FASB issued ASU 2014-12, *Compensation–Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*. These amendments to existing guidance require that a performance target be treated as a "performance condition" if it affects vesting and can be achieved after the requisite service period. To account for such awards, a reporting entity should apply existing guidance in Topic 718 as it relates to awards with performance conditions that affect vesting. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest, and should be adjusted to reflect those awards that ultimately vest. The requisite period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. It was adopted by the Company for the first quarter of 2016, and because our stock compensation practices do not currently utilize performance-based criteria there was no impact upon our financial statements or operations upon adoption.

In April 2015 the FASB issued ASU 2015-03, *Interest–Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*, to simplify the presentation of debt issuance costs related to a recognized debt liability by reflecting those costs as a direct deduction from the carrying amount of debt liability, consistent with debt discounts. ASU 2015-15 was subsequently issued in August 2015 to clarify the SEC staff's position on presenting and measuring debt issuance costs incurred in connection with line-of-credit arrangements. ASU 2015-03, as modified by ASU 2015-15, became effective for interim and annual periods beginning after December 15, 2015, and we adopted this guidance for the first quarter of 2016 without any material effect on our consolidated financial statements.

In January 2016 the FASB issued ASU 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*. This guidance primarily affects the accounting for equity securities with readily determinable fair values, by requiring that the changes in fair value for such securities will be reflected in earnings rather than in other comprehensive income. The accounting for other financial instruments such as loans, debt securities, and financial liabilities is largely unchanged. ASU 2016-01 also changes the presentation and disclosure requirements for financial instruments, including a requirement that public business entities use exit pricing when estimating fair values for financial instruments measured at amortized cost for disclosure purposes. ASU 2016-01 is generally effective for public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. We are evaluating the potential effects of this guidance on our financial statements and disclosures, but do not currently expect it to have a material impact upon adoption.

In February 2016 the FASB issued ASU 2016-02, *Leases (Topic 842)*. This new standard is being issued to increase the transparency and comparability around lease obligations. Previously unrecorded off-balance sheet obligations will now be brought more prominently to light by presenting lease liabilities on the face of the balance sheet, accompanied by enhanced qualitative and quantitative disclosures in the notes to the financial statements. ASU 2016-02 is generally effective for public business entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the potential impact of this guidance on its financial statements and disclosures.

In March 2016 the FASB issued ASU 2016-09, *Compensation–Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*, as part of its simplification initiative. Currently, as they relate to share-based payments, tax benefits in excess of compensation costs (“windfalls”) are recorded in equity, and tax deficiencies (“shortfalls”) are recorded in equity to the extent of previous windfalls, and then to the income statement. ASU 2016-09 will reduce some of the administrative complexities by eliminating the need to track a windfall “pool,” but could increase the volatility of income tax expense. This change is required to be applied prospectively to all excess tax benefits and tax deficiencies resulting from settlements after the date of adoption. ASU 2016-09 also removes the requirement to delay recognition of a windfall tax benefit until it reduces current taxes payable. Under the new guidance, the benefit will be recorded when it arises, subject to normal valuation allowance considerations. This change is required to be applied on a modified retrospective basis, with a cumulative-effect adjustment to opening retained earnings. Furthermore, all tax-related cash flows resulting from share-based payments are to be reported as operating activities on the statement of cash flows, a change from the current requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. However, cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity. Under the new guidance, entities are also permitted to make an accounting policy election for the impact of forfeitures on expense recognition for share-based payment awards. Forfeitures can be estimated in advance, as required today, or recognized as they occur. Estimates will still be required in certain circumstances, such as at the time of modification of an award or issuance of a replacement award in a business combination. If elected, the change to recognize forfeitures when they occur needs to be adopted using a modified retrospective approach, with a cumulative effect adjustment recorded to opening retained earnings. ASU 2016-09 is effective for public business entities for annual reporting periods beginning after December 15, 2016, and interim periods within that reporting period. We are currently evaluating the potential impact of this guidance on our financial statements and disclosures.

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

Note 4 – Supplemental Disclosure of Cash Flow Information

During the nine months ended September 30, 2016 and 2015, cash paid for interest due on interest-bearing liabilities was $2.341 million and $1.957 million, respectively. There was $2.890 million in cash paid for income taxes during the nine months ended September 30, 2016, and $6.390 million in cash paid for income taxes for the nine months ended September 30, 2015. Assets totaling $847,000 and $1.004 million were acquired in settlement of loans for the nine months ended September 30, 2016 and September 30, 2015, respectively. We received $982,000 in cash from the sale of foreclosed assets during the first nine months of 2016 relative to $1.454 million during the first nine months of 2015, which represents sales proceeds less loans (if any) extended to finance such sales.

Cash flow information relative to the Coast acquisition is disclosed in the following table:

Assets acquired (liabilities assumed and capital created) in acquisition (see note 13):	Nine months ended September 30, 2016 (dollars in thousands, unaudited)	2015
Cash and cash equivalents	$18,931	$ -
Securities	$23,363	$ -
Loans	$94,264	$ -
Premises and equipment	$5,844	$ -
Core deposit intangibles	$1,827	$ -
Goodwill	$1,024	$ -
Deferred tax asset	$326	$ -
Other assets	$3,571	$ -
Deposits	$(129,038)	$ -
Other liabilities	$(705)	$ -
Borrowings	$(2,500)	$ -
TRUPS	$(3,422)	$ -
Common Stock	$(10,205)	$ -

<u>Note 5 – Share Based Compensation</u>

The 2007 Stock Incentive Plan (the “2007 Plan”) was adopted by the Company in 2007. Our 1998 Stock Option Plan was concurrently terminated, although options to purchase 28,500 shares that were granted under that plan were still outstanding as of September 30, 2016 and remain unaffected by the plan’s termination. The 2007 Plan provides for the issuance of both “incentive” and “nonqualified” stock options to officers and employees, and of “nonqualified” stock options to non-employee directors of the Company. The 2007 Plan also provides for the issuance of restricted stock awards to these same classes of eligible participants, on such terms and conditions as are established at the discretion of the Board of Directors or the Compensation Committee, although no restricted stock awards have been issued by the Company. The total number of shares of the Company’s authorized but unissued stock reserved for issuance pursuant to awards under the 2007 Plan was initially 1,500,000 shares, although due to awards granted since the inception of the plan the number remaining available for grant had declined to 748,420 at September 30, 2016. No equity awards can be issued under the 2007 Plan on or after March 15, 2017, when the plan expires, but any award granted under the plan prior to March 15, 2017 had, or will have, an original life of 10 years and thus may extend beyond that date. The dilutive impact of stock options outstanding is discussed below in Note 6, Earnings per Share.

Pursuant to FASB's standards on stock compensation, the value of each stock option granted is reflected in our income statement as employee compensation or directors' expense by amortizing the value over the vesting period for options with graded vesting, or by expensing it as of the grant date for immediately vested options. The Company is utilizing the Black-Scholes model to value stock options, and the "multiple option" approach is used to allocate the resulting valuation to actual expense. Under the multiple option approach an employee's options for each vesting period are separately valued and amortized, which appears to be the preferred method for option grants with graded vesting. A pre-tax charge of $11,000 was reflected in the Company's income statement during the third quarter of 2016 and $14,000 was charged during the third quarter of 2015, as expense related to stock options. For the first nine months, the charges totaled $180,000 in 2016 and $33,000 in 2015.

<u>Note 6 – Earnings per Share</u>

The computation of earnings per share, as presented in the Consolidated Statements of Income, is based on the weighted average number of shares outstanding during each period. There were 13,790,107 weighted average shares outstanding during the third quarter of 2016, and 13,358,895 during the third quarter of 2015. There were 13,446,567 weighted average shares outstanding during the first nine months of 2016, and 13,531,370 during the first nine months of 2015.

Diluted earnings per share include the effect of the potential issuance of common shares, which for the Company is limited to shares that would be issued on the exercise of "in-the-money" stock options. For the third quarter of 2016, calculations under the treasury stock method resulted in the equivalent of 114,353 shares being added to basic weighted average shares outstanding for purposes of determining diluted earnings per share, while a weighted average of 146,900 stock options were excluded from the calculation because they were underwater and thus anti-dilutive. For the third quarter of 2015 the equivalent of 123,469 shares were added in calculating diluted earnings per share while 169,300 anti-dilutive stock options were excluded. Likewise, for the first nine months of 2016 the equivalent of 114,149 shares were added to basic weighted average shares outstanding in calculating diluted earnings per share and a weighted average of 196,900 stock options that were anti-dilutive for the period were excluded, compared to the inclusion of the equivalent of 125,377 shares and exclusion of 171,700 anti-dilutive options in calculating diluted earnings per share for first nine months of 2015.

<u>Note 7 – Comprehensive Income</u>

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

that are excluded from other comprehensive income in the current period.

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

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

	September 30, 2016	December 31, 2015
Commitments to extend credit	$ 399,273	$ 354,890
Standby letters of credit	$ 8,456	$ 16,654

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

At September 30, 2016, the Company was also utilizing a letter of credit in the amount of $97 million issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits and to facilitate certain credit arrangements with the Company's customers. That letter of credit is backed by loans which are pledged to the FHLB by the Company.

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

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

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

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would likely consider in pricing an asset or liability.

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. The estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to realized gains and losses could have a significant effect on fair value estimates but have not been considered in those estimates. Because no active market exists for a significant portion of our financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. The estimates are subjective and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly alter the fair values presented. The following methods and assumptions were used by the Company to estimate its financial instrument fair values disclosed at September 30, 2016 and December 31, 2015:

- Cash and cash equivalents and fed funds sold: The carrying amount is estimated to be fair value.
- Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities when quoted prices for specific securities are not readily available.
- Loans and leases: For variable-rate loans and leases that re-price frequently with no significant change in credit risk or interest rate spread, fair values are based on carrying values. Fair values for other loans and leases are estimated by discounting projected cash flows at interest rates being offered at each reporting date for loans and leases with similar terms, to borrowers of comparable creditworthiness. The carrying amount of accrued interest receivable approximates its fair value.
- Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are not relevant for reporting purposes. If available-for-sale loans are on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.
- Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.
- Cash surrender value of life insurance policies: Fair values are based on net cash surrender values at each reporting date.
- Investments in, and capital commitments to, limited partnerships: The fair values of our limited partner investments in low-income housing tax credit funds and other limited partnership investments are estimated using quarterly indications of value provided by the general partners. The fair values of undisbursed capital commitments are assumed to be the same as their book values.
- Other investments: Certain investments for which no secondary market exists are carried at cost and the carrying amount for those investments typically approximates their estimated fair value, unless an impairment analysis indicates the need for adjustments.
- Deposits: Fair values for non-maturity deposits are equal to the amount payable on demand at the reporting date, which is the carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a cash flow analysis, discounted at interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.
- Short-term borrowings: Current carrying amounts are used as an approximation of fair values for federal funds purchased, overnight advances from the Federal Home Loan Bank ("FHLB"), borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days of the reporting dates. Fair values of other short-term borrowings are estimated by discounting projected cash flows at the Company's current incremental borrowing rates for similar types of borrowing arrangements.
- Long-term borrowings: Fair values are estimated using projected cash flows discounted at the Company's current incremental borrowing rates for similar types of borrowing arrangements.
- Subordinated debentures: Fair values are determined based on the current market value for like instruments of a similar maturity and structure.
- Commitments to extend credit and letters of credit: If funded, the carrying amounts for currently unused commitments would provide an equivalent measure of fair values for the newly created financial assets at the funding date. However, because of the high degree of uncertainty with regard to whether or not those commitments will ultimately be funded, fair values for loan commitments and letters of credit in their current undisbursed state cannot reasonably be estimated, and only notional values are disclosed in the table below.

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

Fair Value of Financial Instruments

(dollars in thousands, unaudited)

	September 30, 2016				
		Estimated Fair Value			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets:					
Cash and cash equivalents	$65,442	$65,537	$ -	$ -	$65,537
Investment securities available for sale	535,580	1,129	534,451	-	535,580
Loans and leases, net held for investment	1,249,241	-	1,271,560	-	1,271,560
Collateral dependent impaired loans	165	-	165	-	165
Cash surrender value of life insurance policies	44,191	-	44,191	-	44,191
Other investments	8,506	-	8,506	-	8,506
Investment in limited partnership	8,338	-	8,338	-	8,338
Accrued interest receivable	5,918	-	5,918	-	5,918
Financial liabilities:					
Deposits:					
Noninterest-bearing	$498,391	$498,391	$ -	$ -	$498,391
Interest-bearing	1,135,440	-	1,135,685	-	1,135,685
Fed funds purchased and repurchase agreements	9,270	-	9,270	-	9,270
Short-term borrowings	71,600	-	71,600	-	71,600
Long-term borrowings	-	-	-	-	-
Subordinated debentures	34,365	-	23,288	-	23,288
Limited partnership capital commitment	2,751	-	2,751	-	2,751
Accrued interest payable	97	-	97	-	97

	Notional Amount
Off-balance-sheet financial instruments:	
Commitments to extend credit	$399,273

Standby letters of credit	8,456

	December 31, 2015				
		Estimated Fair Value			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial assets:					
Cash and cash equivalents	$48,623	$48,623	$-	$ -	$48,623
Investment securities available for sale	507,582	1,296	506,286	-	507,582
Loans and leases, net held for investment	1,120,773	-	1,136,386	-	1,136,386
Collateral dependent impaired loans	3,829	-	3,829	-	3,829
Cash surrender value of life insurance policies	44,140	-	44,140	-	44,140
Other Investments	7,546	-	7,546	-	7,546
Investment in limited partnership	6,217	-	6,217	-	6,217
Accrued interest receivable	5,808	-	5,808	-	5,808
Financial liabilities:					
Deposits:					
Noninterest-bearing	$432,251	$432,251	$-	$ -	$432,251
Interest-bearing	1,032,377	-	1,032,547	-	1,032,547
Fed funds purchased and repurchase agreements	9,405	-	9,405	-	9,405
Short-term borrowings	75,300	-	75,300	-	75,300
Long-term borrowings	2,000	-	2,001	-	2,001
Subordinated debentures	30,928	-	7,383	-	7,383
Limited partnership capital commitment	795	-	795	-	795
Accrued interest payable	116	-	116	-	116

	Notional Amount
Off-balance-sheet financial instruments:	
Commitments to extend credit	$354,890
Standby letters of credit	16,654

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For financial asset categories that were actually reported at fair value as of September 30, 2016 and December 31, 2015, the Company used the following methods and significant assumptions:

- Investment securities: Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities.
- Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.
- Foreclosed assets: Repossessed real estate (known as other real estate owned, or "OREO") and other foreclosed assets are carried at the lower of cost or fair value. Fair value is the appraised value less expected selling costs for OREO and some other assets such as mobile homes, and fair values for any other foreclosed assets are represented by estimated sales proceeds as determined using reasonably available sources. Foreclosed assets for which appraisals can be feasibly obtained are periodically measured for impairment using updated appraisals. Fair values for other foreclosed assets are adjusted as necessary, subsequent to a periodic re-evaluation of expected cash flows and the timing of resolution. If impairment is determined to exist, the book value of a foreclosed asset is immediately written down to its estimated impaired value through the income statement, thus the carrying amount is equal to the fair value and there is no valuation allowance.

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

Fair Value Measurements - Recurring

(dollars in thousands, unaudited)

	Fair Value Measurements at September 30, 2016, using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss)
Investment securities					

US Government agencies	$-	$ 24,811	$ -	$24,811	$ -
Mortgage-backed securities	-	396,029	-	396,029	-
State and political subdivisions	-	113,611	-	113,611	-
Other securities	1,129	-	-	1,129	-
Total available-for-sale securities	$1,129	$ 534,451	$ -	$535,580	$ -

	Fair Value Measurements at December 31, 2015, using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Realized Gain/(Loss)
Investment securities					
US Government agencies	$-	$ 29,042	$ -	$29,042	$ -
Mortgage-backed securities	-	375,061	-	375,061	-
State and political subdivisions	-	102,183	-	102,183	-
Other securities	1,296	-	-	1,296	-
Total available-for-sale securities	$1,296	$ 506,286	$ -	$507,582	$ -

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

Fair Value Measurements - Nonrecurring

(dollars in thousands, unaudited)

	Fair Value Measurements at September 30, 2016, using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans				
Real Estate:				
1-4 family residential construction	$-	$ -	$ -	$-
Other construction/land	-	70	-	70
1-4 family - closed-end	-	-	-	-
Equity lines	-	-	-	-
Multi-family residential	-	-	-	-
Commercial real estate - owner occupied	-	-	-	-
Commercial real estate - non-owner occupied	-	69	-	69
Farmland	-	-	-	-
Total real estate	-	139	-	139
Agriculture	-	-	-	-
Commercial and industrial	-	-	-	-
Consumer loans	-	26	-	26
Total impaired loans	-	165	-	165
Foreclosed assets	$-	$ 2,782	$ -	$2,782
Total assets measured on a nonrecurring basis	$-	$ 2,947	$ -	$2,947

	Fair Value Measurements at December 31, 2015, using			
	Quoted Prices	Significant Observable	Significant Unobservable	Total

	in Active Markets for Identical Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)	
Impaired loans				
Real Estate:				
1-4 family residential construction	$-	$ -	$ -	$-
Other construction/land	-	179	-	179
1-4 family - closed-end	-	499	-	499
Equity lines	-	30	-	30
Multi-family residential	-	-	-	-
Commercial real estate - owner occupied	-	26	-	26
Commercial real estate - non-owner occupied	-	3,053	-	3,053
Farmland	-	-	-	-
Total real estate	-	3,787	-	3,787
Agriculture	-	0	-	-
Commercial and industrial	-	0	-	-
Consumer loans	-	43	-	43
Total impaired loans	-	$ 3,830	-	3,830
Foreclosed assets	$-	$ 3,193	$ -	$3,193
Total assets measured on a nonrecurring basis	$-	$ 7,023	$ -	$7,023

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

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

Note 10 – Investments

Investment Securities

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

Amortized Cost And Estimated Fair Value

The amortized cost and estimated fair value of investment securities available-for-sale are as follows (dollars in thousands, unaudited):

	September 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
US Government agencies	$24,555	$ 277	$ (21)	$24,811
Mortgage-backed securities	392,831	3,957	(759)	396,029
State and political subdivisions	109,663	4,027	(79)	113,611
Other securities	500	629	-	1,129
Total investment securities	$527,549	$ 8,890	$ (859)	$535,580

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value

US Government agencies	$	28,801	$	303	$	(62	)	$	29,042
Mortgage-backed securities		374,683		2,440		(2,062	)		375,061
State and political subdivisions		99,093		3,146		(56	)		102,183
Other securities		575		721		-			1,296
Total investment securities	$	503,152	$	6,610	$	(2,180	)	$	507,582

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At September 30, 2016 and December 31, 2015, the Company had 120 securities and 175 securities, respectively, with unrealized losses. Management has evaluated those securities as of the respective dates, and does not believe that any of the unrealized losses are other than temporary. Gross unrealized losses on our investment securities as of the indicated dates are disclosed in the table below, categorized by investment type and by the duration of time that loss positions on individual securities have continuously existed (over or under twelve months).

Investment Portfolio - Unrealized Losses

(dollars in thousands, unaudited)

	September 30, 2016			
	Less than twelve months		Twelve months or more	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
US Government agencies	$ (21)	$ 8,791	$ -	$ -
Mortgage-backed securities	(403)	75,402	(356)	48,182
State and political subdivisions	(79)	7,794	-	-
Total	$ (503)	$ 91,987	$ (356)	$ 48,182

	December 31, 2015			
	Less than twelve months		Twelve months or more	
US Government agencies	$ (62)	$ 10,329	$ -	$ -
Mortgage-backed securities	(1,608)	187,734	(454)	35,511
State and political subdivisions	(17)	3,409	(39)	3,847
Total	$ (1,687)	$ 201,472	$ (493)	$ 39,358

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

Investment Portfolio - Realized Gains/(Losses)

(dollars in thousands, unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Proceeds from sales, calls and maturities of securities available for sale	$19,723	$198	$24,948	$24,988
Gross gains on sales, calls and maturities of securities available for sale	$90	$108	$250	$630
Gross losses on sales, calls and maturities of securities available for sale	-	-	(38)	(199)
Net gains on sale of securities available for sale	$90	$108	$212	$431

The amortized cost and estimated fair value of investment securities available-for-sale at September 30, 2016 and December 31, 2015 are shown below, grouped by the remaining time to contractual maturity dates. The expected life of investment securities may not be consistent with contractual maturity dates, since the issuers of the securities could have the right to call or prepay obligations with or without penalties.

Estimated Fair Value of Contractual Maturities

(dollars in thousands, unaudited)

	September 30, 2016	
	Amortized Cost	Fair Value
Maturing within one year	$5,997	$6,123
Maturing after one year through five years	262,158	265,993
Maturing after five years through ten years	42,306	43,665
Maturing after ten years	49,086	50,579
Investment securities not due at a single maturity date:		
U.S Government agencies collateralized by mortgage obligations	167,502	168,091
Other securities	500	1,129
	$527,549	$535,580

	December 31, 2015	
	Amortized Cost	Fair Value
Maturing within one year	$3,657	$3,706
Maturing after one year through five years	242,719	244,733
Maturing after five years through ten years	50,144	51,308
Maturing after ten years	50,413	51,671
Investment securities not due at a single maturity date:		
U.S Government agencies collateralized by mortgage obligations	155,644	154,868
Other securities	575	1,296
	$503,152	$507,582

At September 30, 2016, the Company's investment portfolio included securities issued by 314 different government municipalities and agencies located within 32 states with a fair value of $113.6 million. The largest exposure to any single municipality or agency was a $926,000 (fair value) bond issued by the Northern Inyo County Hospital District in California, to be repaid by property taxes.

The Company's investments in bonds issued by states, municipalities and political subdivisions are evaluated in accordance with Supervision and Regulation Letter 12-15 issued by the Board of Governors of the Federal Reserve System, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings," and other regulatory guidance. Credit ratings are considered in our analysis only as a guide to the historical default rate associated with similarly-rated bonds. There have been no significant differences in our internal analyses compared with the ratings assigned by the third party credit rating agencies.

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

Revenue and General Obligation Bonds by Location

(dollars in thousands, unaudited)

	September 30, 2016		December 31, 2015	
General obligation bonds	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
State of issuance				
California	$23,109	$23,384	$20,473	$21,642
Texas	19,977	20,493	16,575	16,954
Illinois	10,216	10,511	9,997	10,191
Ohio	9,041	9,287	7,610	7,748
Washington	6,009	6,213	5,905	6,081
Arizona	1,801	1,870	2,039	2,108
Utah	950	1,002	953	990
Other states	19,533	21,198	20,334	20,848
Total General Obligation Bonds	90,636	93,958	83,886	86,562
Revenue bonds				
State of issuance				
Texas	5,744	5,913	3,732	3,863
Utah	4,852	5,024	4,434	4,519
Washington	1,304	1,374	1,791	1,827
California	1,256	1,291	1,002	1,028
Ohio	317	318	318	319
Other states	5,554	5,733	3,930	4,065
Total Revenue Bonds	19,027	19,653	15,207	15,621
Total Obligations of States and Political Subdivisions	$109,663	$113,611	$99,093	$102,183

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

Revenue Bonds by Type

(dollars in thousands, unaudited)

	September 30, 2016		December 31, 2015	
Revenue bonds	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
Revenue source:				
Water	$4,269	$4,387	$3,942	$4,052
College & University	3,411	3,575	2,975	3,103
Sales Tax	2,987	3,084	2,630	2,663
Lease	2,495	2,563	2,040	2,100
Electric & Power	942	958	679	691
Other sources	4,923	5,086	2,941	3,012
Total Revenue Bonds	$19,027	$19,653	$15,207	$15,621

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

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

The Company invested in seven LIHTC fund limited partnerships from 2001 through 2007, and in the second quarter of 2016 we committed $3 million to another such fund. Our investments to date have all been in California-focused funds which help the Company meet its obligations under the Community Reinvestment Act. We utilize the equity method of accounting for our LIHTC fund investments. Under the equity method, our balance sheet initially reflects an asset that represents the total cash expected to be invested over the life of the partnership. Any commitments or contingent commitments for future investment are reflected as a liability. The income statement treatment under the equity method reflects tax credits received by the Company "below the line" within the income tax provision, while fund operating results are included "above the line" in non-interest income. As noted above, operating results are typically losses that are netted against non-interest income.

As of September 30, 2016 our total LIHTC investment balance was $7.1 million, which includes $2.1 million in remaining commitments for additional capital contributions to the limited partnerships. There were $515,000 in tax credits derived from our LIHTC investments that were recognized during the nine months ended September 30, 2016, and a pass-through operating loss of $788,000 associated with those investments was included in pre-tax income for the same time period. Our LIHTC investments are evaluated annually for potential impairment, and we have concluded that the carrying value of the investments is stated fairly and is not impaired.

Note 11 – Credit Quality and Nonperforming Assets

Credit Quality Classifications

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

- Pass: Larger non-homogeneous loans not meeting the risk rating definitions below, and smaller homogeneous loans that are not assessed on an individual basis.
- Special mention: Loans which have potential issues that deserve the close attention of Management. If left uncorrected, those potential weaknesses could eventually diminish the prospects for full repayment of principal and interest according to the contractual terms of the loan agreement, or could result in deterioration of the Company's credit position at some future date.
- Substandard: Loans that have at least one clear and well-defined weakness that could jeopardize the ultimate recoverability of all principal and interest, such as a borrower displaying a highly leveraged position, unfavorable financial operating results and/or trends, uncertain repayment sources or a deteriorated financial condition.
- Impaired: A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include all nonperforming loans and restructured troubled debt ("TDRs"). A TDR may be nonperforming or performing, depending on its accrual status and the demonstrated ability of the borrower to comply with restructured terms (see "Troubled Debt Restructurings" section below for additional information on TDRs).

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

Credit Quality Classifications

(dollars in thousands, unaudited)

	September 30, 2016				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$31,239	$-	$ -	$-	$31,239
Other construction/land	24,292	5,575	-	1,102	30,969
1-4 family - closed end	129,265	636	418	6,686	137,005
Equity lines	35,387	1,658	698	4,006	41,749
Multi-family residential	29,881	-	-	413	30,294
Commercial real estate - owner occupied	238,739	4,144	3,000	2,504	248,387
Commercial real estate - non-owner occupied	209,662	4,798	3,242	1,820	219,522
Farmland	131,746	1,039	2,846	295	135,926
Total real estate	830,211	17,850	10,204	16,826	875,091
Agricultural	51,826	725	-	89	52,640
Commercial and industrial	108,296	19,294	351	2,146	130,087
Mortgage Warehouse	185,865	-	-	-	185,865
Consumer loans	10,588	277	34	1,748	12,647
Total gross loans and leases	$1,186,786	$38,146	$ 10,589	$20,809	$1,256,330

	December 31, 2015				
	Pass	Special Mention	Substandard	Impaired	Total
Real Estate:					
1-4 family residential construction	$13,784	$1,157	$ -	$-	$14,941
Other construction/land	35,901	135	-	1,323	37,359
1-4 family - closed end	127,972	2,498	387	6,499	137,356
Equity lines	39,966	199	957	3,111	44,233
Multi-family residential	26,178	-	-	1,044	27,222
Commercial real estate - owner occupied	196,211	12,075	7,322	3,100	218,708
Commercial real estate - non-owner occupied	155,223	4,505	170	5,209	165,107
Farmland	130,285	1,563	724	610	133,182
Total real estate	725,520	22,132	9,560	20,896	778,108

Agricultural	46,197	40	-	-	46,237
Commercial and industrial	108,931	933	755	2,588	113,207
Mortgage Warehouse	180,355	-	-	-	180,355
Consumer loans	12,718	178	16	2,037	14,949
Total gross loans and leases	$ 1,073,721	$ 23,283	$ 10,331	$ 25,521	$ 1,132,856

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Past Due and Nonperforming Assets

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

Loan Portfolio Aging

(dollars in thousands, unaudited)

	September 30, 2016						
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or More Past Due[1]	Total Past Due	Current	Total Financing Receivables	Non-Accrual Loans[2]
Real Estate:							
1-4 family residential construction	$-	$ -					